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TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

Vol 4

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Techniques of Investigation for Assessment

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Foreword

In the rapidly changing economic scenario, where the economic transactions are happening across the borders and becoming more and more complex by the day, the tax authorities are required to keep themselves updated on the important developments in various trades and industries. The latest information on the cutting-edge developments in various sectors of economy are a must for the tax investigators. Therefore, a need was felt to revise the write-ups on various important, as well as upcoming sectors of economy, as a lot of changes have occurred since the existing *'Manual on Techniques of Investigation'* was last released in the year 2002.

Two volumes (i.e. Volume 1 and 2) of the Manual have already been revised. Volume 3 and 4 of this Manual have also been updated now.

Volume 3 covers twenty industries and trade, encompassing conventional manufacturing, hospitality and services industry. The impact of introduction of GST and GST related tax evasion has been discussed in relevant chapters. The use of Tally and ERP software for tax evasion has also been explained with examples in the chapter 'Engineering Industry'. Further, tax-related issues arising in Joint Ventures with foreign multi-national corporations and foreign manufacturers, the TP issues, analysis of segment wise performance have also been discussed in the chapter 'Automobile Industry'. The tonnage scheme and the issues involved in international shipping companies have been incorporated in the Chapter on 'Shipping Industry'.

Volume 4 contains write-up on ten sectors of industry and economy including multi-national corporations, information technology companies, e-Commerce, broadcasting and television industry, event management & advertisement industry. The contemporary tax related challenges pertaining to these sectors of industry have been discussed in a nuanced manner.

I would like to reiterate my special appreciation for the efforts of all the members of the Committee and other officers associated with the enormous task of updating and writing this Manual. I hope that these Volumes shall be able to meet the expectations of all the stakeholders and would act as a guiding light while conducting tax-related investigations.

New Delhi
Dated: 09/09/2019

(Pramod Chandra Mody)
Chairman and Member (Investigation)[i/c]
Central Board of Direct Taxes

Preface

What one reads and retains has a vast bearing on what one reads and retains after that. This dictum has a lot of relevance today and starting on the right track ensures that one remains on the right path. Similarly, the need for continuously updating ourselves can never be understated, more so in the context of everfevolving tax scenario and litigation. With these objectives in mind, CBDT had undertaken the review of its primary publication "Techniques of Investigation Manual" (Vol. I to V) 2002, to disseminate information concerning the changing trends in various Industries and to provide a primer for further research. Accordingly, a Committee was constituted to review and update the publications and the Committee had decided to bring the manual in seven volumes. The first two volumes had introductory and general chapters whereas the rest of the volumes would cover specific business/ industry wise writeups.

It is crucial that the tax officers are encouraged to think about better ways to prevent evasion of tax and to offer superior tax payer services. Today's world is a huge knowledge driven economy and knowledge management is the key to enhanced prestige of any organisation that seeks to improve the manner in which its officers share, access, and update business knowledge and information. The new series of 'Techniques of Investigation' is the requirement of the time. The CBDT is aware that good work done by individual officers often goes undocumented, or is difficult to access or is at risk of disappearing too. It is expected that the new series would allow officers to have a better grasp of the newer concepts and equip them with better insight.

The new publications aim to present the tax related issues pertaining to various industries traditional as well as new technical and technological fields. It seeks also to familiarise the officers with the crucial work flows in each. The Indian economy is at the threshold of a new era of transparency, openness and growth. It is trite that taxation forms a crucial element in all the above and proper implementation of tax laws is a paramount concern. The new publications thus seek to contribute towards an effective administration of tax laws in the country.

Volume 1 in the new series had dealt with general tax administration, investigation of accounts and drafting of good assessment orders, the Volume 2 had chapters on commodity markets, penny stock & shell corporations, coordination with other agencies, hawala and benami transactions etc. The Volume 3 had continued the seminal work with chapters on money & currency markets, woollen hosiery & newspaper industry among others as well as foreign exchange transactions and dealers. Continuing the work forward, the Committee has great pleasure in now bringing out the Volume 4 of the Manual. The present volume seeks to offer an insight into tax issues bedevilling tax matters in the case of ten sectors including multinational transactions, information technology, e-Commerce, broadcasting and television industry, event management & advertisement industry etc. It is my belief that this volume shall be able to meet the stakeholders' expectations and address some of the contemporary challenges that may come our way.

Our Department occupies a unique place in the scheme of implementation and administration of tax laws and the officers are expected to collect due taxes in a fair and transparent manner. The onus is heavy but the Committee is confident that the new series on 'Techniques of Investigation' would go a long way in assisting the officers to fulfil their duties. The Committee acknowledges the effort of all the officers who have contributed towards the present compilation and is thankful to the Editorial Board for their meticulous editing and formatting. The Committee takes this opportunity to also look back at the distance travelled so far and pay our regards to the officers who had worked on the older version of the publication. Their contribution was seminal and it had given a sense of direction to the present team.

N.P. Sinha

Chairman of the Committee

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CHAPTER 1

Multinational Corporations

1. INTRODUCTION

1.1 Multinational enterprises (MNEs) or corporations (MNCs) are businesses that operate in many different countries at the same time. Rapid globalization in recent decades and specifically increasing technical and technological sophistication and faster means of transport and communication, have resulted in shrinkage of the perceived geographical span of the world. Businesses that used to mainly operate in limited geographical territories, now reach out to global markets and establish their presence in the form of offices, factories, presence of personnel or carry out their activities remotely via teleconferencing, internet etc., targeting global expansion and profit maximization. A secondary aim of shifting the activities to tax haven or low tax jurisdiction countries also governs an MNC's presence across multiple tax jurisdictions. While taxing such entities, tax authorities have to maintain the delicate balance of ensuring that a fair share of the overall tax burden is born by the MNC within their jurisdiction, while adhering to the requirements of international conventions and ensuring that genuine businesses are not affected.

1.2 Owing to their simultaneous functioning either directly or indirectly in multiple tax jurisdictions, taxation of MNCs is a complex issue. It is distinct from taxation of domestic companies on account of involvement of different factors such as:

a. A domestic company is a resident company and its global income derived from all sources is taxed in India; for an MNC the degree of its presence, involvement, operation etc. in India needs to be examined to ascertain whether and to what extent its activities are taxable in India.

b. An MNC is taxed as per the provisions of the Incometax Act, but wherever it claims to be a resident of another country, the corresponding Double Taxation Avoidance Agreement (DTAA) comes into picture to restrict the scope of the domestic legislation. In such a scenario, for an MNC to be liable for taxation in India, specific conditions laid out in the DTAA needs to be satisfied.

c. At times an MNC will operate in India for clear and limited purposes only, in which

case it may be offering its income under specific heads such as royalty or FTS on gross basis. However, in most cases, all facts need to be marshaled to examine all the sources of income or activities pertaining to India which are revenue yielding, to verify the correctness and the adequacy of the taxes paid by the assessee in India.

d. Specifically in all cases where income of the assessee is not characterized under a clear head, it is likely to be classified as income from general business activities. In such a cases, if the assessee is a resident of a country with which India has a tax treaty, it becomes important to examine whether the assessee has a Permanent Establishment (PE) in India, a concept that is present in all DTAAs. If the income of the assessee is accepted to be emanating exclusively from business activities and the corresponding DTAA has the requirement of taxation of business income on the grounds of it having a PE in India, then the income can only be taxed w.r.t. activities attributable to the PE. This concept is discussed in details in subsequent paragraphs.

e. An MNC may operate through multiple entities, and may be involved in multilayered transactions which may need to be studied in isolation, as well as in totality to understand the taxation implications of the same.

2. GENERAL ISSUES IN TAXATION OF MNCs

MNCs operating in India, have the same general issues of taxation such as those in the taxation of foreign companies i.e. taxation of receipts as royalty, taxation of receipts as Fee for Technical Services (FTS), and taxation on account of business income w.r.t. profits attributable to an MNC's business connection (as per the Act) or the permanent establishment ('PE') in India (as per the DTAA). Income may also be in the nature of specific types incomes such as interest income. As per the general rule of taxation in accordance with tax treaties, it first needs to be seen whether an income is chargeable to tax under the Act. Once an income is chargeable to tax under the Act, specific relief needs to be provided as per the applicable DTAA. By its very nature, the scope of taxation under the DTAA is narrower than the scope of taxation under the Act, as Treaty is applied to provide relief. In fact, the domestic law in India provides that the provisions of the Act shall apply if they are more beneficial to the assessee (Section 90(2)2 of the Act). Therefore, once an income is held taxable under the Act, it also needs to be established that it meets the more stringent conditions laid down in the DTAA (if applicable).

3. TAXATION OF BUSINESS INCOME OF MNCs

3.1 Taxation of business income is different from taxation of specific receipts such as royalty and FTS. The general rule of interpretation is– the special provisions will override the general provisions. Hence, if an income falls specifically in any of the Articles of DTAA–such as royalty or FTS or interest, it will be covered by those articles. This means that if an AO finds that a particular income is in the nature of royalty, FTS etc. under the Act and the corresponding DTAA under which relief is being sought has a specific Article dealing with such an income, then relief if any would be considered under that specific Article. Only when such income is effectively connected to the permanent establishment in India does such type of income gets covered under profits from business activities, and generally the Articles on interest, royalty etc. provide for such treatment. For business income to be taxed in a jurisdiction, existence of connection between the income and activity performed in that jurisdiction is a must as specified in Section 9(1)(i) of the Act. Once a business connection is determined, in order to tax the income of the assessee as per DTAA, existence of a Permanent Establishment (PE)

and activities/ profits attributable to the same needs to be determined.

3.2 The global business environment is constantly changing with new technologies and solutions being deployed for more efficient conduct of business. Due to involvement of multiple entities, complicated or seemingly complicated and multiple transactions, use of unique technological solutions and other factors typical to a large MNC operation, examining whether an MNC has a PE in India is a complex matter and requires indepth investigation and unearthing of all facts of the case. The manner in which the same can be done and the broad approach the Assessing Officer ('AO') may adopt while examining the likelihood of a PE existing in a case, as well as determining the profits attributable to the PE which can be held as taxable in India, are discussed in subsequent paragraphs. The Finance Act, 2018 has introduced a new Explanation 2A with effect from 01.04.2019 to deal with the changing business environment and ways of doing business with the rapid strides made in ICT.

4. CONCEPT OF BUSINESS CONNECTION

4.1 Unlike domestic companies, where all business income is undisputedly taxed in India, for foreign companies including MNCs, taxation of business income is specifically provided for in Section 9 of the Act, WHICH DEALS WITH ONE SEGMENT OF Section 5–that pertaining to income deemed to accrue or arise in India. In general, business profits of non-residents are taxable in India by virtue of **Section 9(1)(i)** which states that income accruing or arising through or from any business connection in India.

4.2 It is also specified that in case of a business in which all the operations are not carried out in India, the income of the business deemed under this Clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India. Thus the conditions for taxing business income of a foreign company (which includes MNCs) in India under the I T Act, are–existence of a business connection, income accruing or arising from the said business connection, and reasonable attribution of income to operations carried out in India.

4.3 The term business connection was not defined specifically in the Act (that is, prior to insertion of Explanation 2A to Section 9(1)(i) with effect from 01.04.2019). But from the evolution of the concept through usage and through judicial decisions, in order to **constitute a business connection**, following conditions need to be satisfied:

a. **Real & intimate relation** must exist between trading/ commercial activities outside India and the activities within India.

b. The relation **contributes** directly or indirectly **to earning income** by the non-resident in his business.

c. The Continuity of relationship between activity outside and within India would be relevant for determining business connection.

4.4 It is clear from the above that a business connection connotes a wide range of relationships, which would invite taxation in the source state. This may lead to difficulty in conduct of normal trading businesses. Hence, specific exclusions are provided by way of Explanation1 to Section 9(1)(i) of the Act to certain type of activities.

4.5 In cases where assesses are non-residents in India but residents of countries with which India has no DTAA, the business income accruing or arising through or from a business connection in India will be taxable in India by virtue of this Section 9(1)(i) of the Act. However, in other cases where India has entered into DTAAs, to address this issue of double taxation, the concept of permanent establishment has been brought in through **Article 5** of DTAAs.

4.6 The broad scope of business connection as provided in Section 9(1)(i) of the Act, is **restricted** by the concept of **permanent establishment** embodied in DTAA. This is because where an assessee is a resident of a country with which India has entered into a DTAA, business profits in case of non-residents are taxable in India, only if there is a PE in India as per the DTAA, and not merely because a business connection exists as per Section 9(1)(i) of the Act.

4.7 Once it is established by a factual analysis that there exists a business connection in a case, if the MNC is found eligible to seek the benefits of a DTAA, then the existence of permanent establishment as per Article 5 needs to be established. The DTAAs entered into by India generally restrict the scope of taxation of domestic legislations in relation to business profits. In accordance with the same, the scope of permanent establishment is narrower than that of a business connection. PE is essentially a compromise between the two states with respect to taxation in favour of promotion of trade and commerce as it denotes a term **more concrete** and **ascertainable than a business connection.**

5. CONCEPT OF PERMANENT ESTABLISHMENT (PE)

5.1 Under **Article 7** of tax treaty, a Contracting State cannot tax the business profits of an enterprise of the other Contracting State unless it carries on its business through a 'PE' situated therein (exception being incomes otherwise taxable on gross basis, such as royalty, fees for technical services, interests etc.). Thus, concept of a PE is relevant for determining the right of a Source State (India in this case) to tax the Business Profits of the foreign enterprise covered by tax treaty.

5.2 Paragraph 1 of **Article 5** of Tax treaties broadly explains the term permanent establishment, as a fixed place of business through which the business of an enterprise is wholly or partly carried out. (For the sake of illustration, specific references to Paragraphs of Article 5 are Paragraphs as given in the model UN convention, the numbering and arrangement of Paragraphs may vary from treaty to treaty). However, this definition is not rigid and is to be interpreted as per the facts of a case and will depend upon various factors such as the nature of business of the assessee, activities involved in the same, the mode of conduct of such business, level of expertise, skill required, terms of relevant agreement and contractual obligations of the assessee under the same.

5.3 Paragraph 2 and Paragraph 3 of Article 5 provides for **specific inclusions** by giving an illustrative list of what is included in the term permanent establishment (e.g. place of management, branch, office, building site or construction, furnishing of services in the contracting state etc.). Similarly, **Paragraph 4** of Article 5 provides for **exclusions** by giving an illustrative list of what is deemed to be not included in the term permanent establishment (e.g. use of facilities solely for the purpose of storage, display etc.)

5.4 However, the lists are merely indicative and not strictly compartmentalized definitions. Whether for a non-resident permanent establishment exists or not, can only be examined and established after thorough analysis of all receipts, documents such as contractual agreements, personnel of the general enterprise (GE) deployed in India, nature of activities carried out or services rendered, risks and responsibilities assumed in India etc.

5.5 From the above discussion it emerges, that to determine whether the **business profits of a non-resident enterprise are taxable in India and the quantum thereof**, two stages are involved. The first stage is **PE formation** i.e. ascertaining and establishing whether a PE of the non-resident exists in India. The second stage is **attribution of income to the PE,** that will be taxable in India.

6. ESTABLISHING THE EXISTENCE OF PE IN INDIA AND TYPES OF PE

Under the DTAA broadly there are the following 4 types of PE:

a. Fixed place PE

b. Project PE

c. Agency PE

d. Service PE

The issues to be examined and broad contours of investigation for determining each kind of PE are discussed below.

6.1 Fixed Place PE

6.1.1 Article 5(1) of the DTAA, defines PE as a **fixed place of business** through which the business of the non-resident is wholly or partly carried out. Examples of such places as included in Article 5(2) of PE include branch, office, factory, workshop etc. Thus under Article 5(1), PE exists if all the **following conditions** are satisfied cumulatively:

a. There is a **place of business** ("place of business test").

b. Such place of business is at the **disposal** of enterprise or the taxpayer must have a certain right of use over the fixed place of business ("disposal test").

c. Such place of business is **fixed geographically and it** must last for a **certain period in time** ("location test" and "permanence test").

d. The **business** of the enterprise is **carried on** ("business activity test") wholly or partly through such fixed place of business.

6.1.2 Thus for ascertaining the existence of a fixed place PE in a case, the existence of the above conditions must be verified from the facts of the case. The presence of the non-resident assessee through a PE should be visible in India and is usually linked to a geographical location. A geographically **location** that is **relatively stable** and under some degree of control of the assessee, and where at least some part of the **business activities** of the assessee are carried out, is indicative of the presence of a fixed place PE.

6.1.3 The term **'place of business'** covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. Place of business may be created where certain amount of space is available even if the same may not be available for the exclusive use of the assessee. There must be geographical and commercial coherence.

6.1.4 Fixed place of business implies that the place of business should have a certain **degree of stability** in terms of location and duration, in relation to the specific type of business being carried out. A PE **may exist** where there is a geographical link (locational test) although activities of enterprise are mobile over a geographical area in view of the specific nature of such activities (e.g. Drilling activity).

6.1.5 A certain degree of permanence (Permanence test) is a feature of such a place of business. However, permanent **does not mean everlasting**. It is used in contradistinction to something fleeting, transitory or casual, and also relates to the specific type or nature of the business.

6.1.6 The premise has to be **at the disposal** of the enterprise during the period (power of disposition). But legal right over the place is not necessary. Thus the **premise may be owned, rented or otherwise at the enterprise's disposal**, and fixed place does not denote owned premises. It is also not necessary that the foreign enterprise alone has the power of disposition. However, mere presence would not constitute a fixed place.

6.1.7 The concept of fixed place PE covers premises as well as tangible assets used for carrying on business. Human element is not a necessary criteria for establishing a fixed place of business. Hence, a server/ machinery/ equipment

may be treated as place of business depending upon the nature of business. Para 17 of the OECD Model Commentary states that a PE may exist if the business of the enterprise is carried on mainly through automatic equipment and the activities of the personnel are restricted to setting up, operating, controlling and maintaining such equipment; thus, **even existence of a computer server** may amount to existence of a PE within a jurisdiction.

> *In a case in US involving participation of a non-resident person owning a racing stable in a horse race, the existence of a racing stable was treated as a fixed place of business giving rise to a PE.*

Thus depending on how important a **role the place of business plays in the conduct of business activities** of the assessee, such place of business may be treated as a fixed place PE.

6.1.8 For satisfying the **permanence condition or duration test**, availability of a fixed place of business for a reasonable period is to be examined. Thus an isolated activity will not lead to establishment of a fixed base PE as the ingredients of **regularity**, **continuity** and **repetitiveness** are essentially missing. However, if the nature of business is such that it can be carried out only for short period (e.g. car race), it will create a PE. Thus **short duration activities** can constitute a PE depending upon the **recurrence** of the activities and **nature of business** as held in the case of Formula One World Championship Limited [2017] TS161SC2017.

6.1.9 A PE **commences** or comes into existence as soon as the assessee commences business through the premise. A PE will **cease to exist** if business is no longer carried, fixed place of business is disposed off and all the connected activities of business are stopped (temporary interruptions in running business are not to be considered). This issue has been dealt with later in this Chapter.

6.1.10 It is also important to examine the nature of **business activities** being carried out at these premises. The foreign entity must carry out its own business activity (partly or wholly) through the PE. The business activity should also **relate to the income sought to be taxed**. The business activity must **not** be of only preparatory or auxiliary character. Such activities are deemed to be excluded from the definition of a PE (e.g. as per Article 3(e) of India USA DTAA). Therefore, notwithstanding the presence of a fixed place, if the activity carried on through such a place of business is preparatory and auxiliary for the General enterprise or non-resident assessee ('GE'), then no PE can be said to exist. The activities should contribute to earning of income of the non-resident (income generating activities).

6.1.11 Activity need not be of "productive character" but it should be connected to core activity–i.e. the PE should contribute to the business earnings. For instance, activity test could be satisfied, by having personnel or automatic equipment at fixed place.

6.1.12 Paragraph 8 of Article 5 specifies that a **subsidiary company** on its own will not constitute a PE of a non-resident company. Thus, ordinarily, a subsidiary would normally not constitute a PE. However, a subsidiary may be taken as constituting a PE for the non-resident, if it **renders significant activities on behalf** of the non-resident.

6.1.13 As business income of an MNC can only be taxed in India if existence of a PE is established, various strategies may be used by companies to circumvent PE provisions of tax treaties including those pertaining to fixed place PE. There may be cases where the assessee has a fixed place in the form of a liaison office (approved for performing limited and specific functions by RBI), but claims that the liaison offices (LO) have limited role in the conduct of business, which does not lead to the establishment of a PE of the GE in India. For instance, in such cases it may be claimed by the assessee that:

a. LOs are only performing limited roles such as collecting information about potential customers in India and passing information to non-resident businesses, creating awareness of business products etc., and these activities were preparatory and auxiliary in nature and do not pertain to the core revenue yielding business activities.

b. All terms of contracts, agreements etc., are entered by the foreign company or GE from outside India.

c. No core activities can be attributable to such fixed places and, therefore, it did not have a fixed place PE in India as it carries out all core activities entirely from outside India.

It is important to note that such claims can also be made w.r.t. office of an Indian AE or a similar premise the personnel of GE have an access to.

6.1.14 In such cases, it is important to verify the genuineness of the claim of the assessee by detailed queries as well as by action u/s 133A, 131 of the Act etc., to ascertain what are the real functions carried out by the assessee. Following points of investigation/ illustrative findings may indicate the probability of a fixed place PE in India:

a. GEs expatriates permanently using its liaison office at the premises. They may also have designated spaces/chambers/ offices under their control. In such cases such expatriates' offices may be treated as fixed places from which business is being carried out.

b. GEs expatriates may be deputed by GEs, who may be performing core activities, they may also be working in tandem with employees of Indian related party for performance of such functions.

c. Contrary to what the assessee might be stating, core business activities are being carried out in India by employees of liaison office.

d. Aside from documents like books of accounts, email communications details of manager assessment, performance appraisals of employees can also yield the details of functions being performed through the liaison office.

e. If it is established that the activities carried out from the premise are core business activities and not in the nature of preparatory and auxiliary activities, the building itself may be considered to be a fixed place PE.

f. It could be established that the nature of business was such that it could not for all practical purposes be done remotely for instance if it's a sale transaction then price negotiations etc., if done by Indian AE or liaison office could be considered to be a core activity being done by the liaison office.

g. Expat could be heading operations of GE in India–working at leading positions, managing business.

h. It is clear from the above, that it is not just the nature of specific activity, but the position of that activity in the chain of activities for that particular business visavis its criticality to the conduct of business, that will determine whether it's a core activity or not. Thus it is not simply that an activity is necessary for the completion of a contract it must be the case that the activities must be critical for the realization of profits.

i. Determining whether a practice is preparatory or auxiliary requires asking whether the activity undertaken at the fixed place of business is an essential and significant part of the activity of the enterprise as a whole.

j. Involvement of the LO in activities, the degree of control also needs to be examined.

k. Moreover, if Fixed place PE is being established, it is important to note that authority to conclude contract by Agency PE is not a precondition. This is because a Fixed place PE is governed under Article 5, Para 3 and the condition of contract conclusion is provided for under Article 5, Para 4 of the DTAA w.r.t. Agency PE (discussed later).

The Hon'ble Delhi High Court in its recent decision dated 21.12.2018 in the case of GE Energy Parts Inc and others (ITA No. 621 of 2017 and connected matters) has upheld the decision of the Revenue to tax liaison office where expats of GE being key employees were performing core activities related to the business, as Fixed place PE.

6.2 Project PE

6.2.1 Project PE defined in **Paragraph 3** of Article 5, comes into existence in cases of construction or installation projects. A building or construction or installation project constitutes a PE if it lasts **over a designated period** (6 months, 120 days etc. depending upon the specific DTAA).

6.2.2 Paragraph 3 specifies that the term 'permanent establishment' encompasses *a building site, a construction, assembly or installation project or supervisory activities in connection therewith.* The term **building site or construction or installation project** includes not only construction of building but also construction of roads, bridges, canals, laying of pipe lines, excavating and dredging. It can also cover demolition and clearing operation and installation of new plant & equipment in place of existing one. Renovation work, that is more substantive than mere maintenance or redecoration of buildings, roads, bridges or canals etc., can also be included in this definition. Planning and supervision of these activities are also covered in this definition. Further, the DTAAs entered into by India generally use the word 'or' before mentioning *supervisory activities in connection therewith,* as against the word 'and' used in the OECD Model Convention, thereby signifying that supervisory activities *per se* could lead to establishment of a project PE.

6.2.3 As with fixed place PE, for project PE as well, seasonal or other temporary interruptions are included in determining the life of the project. Time spent in relocation of project/ office would also be included in determining the life of the project. It is irrelevant whether the prolongation was unexpected as was caused by geological or other difficulties. It also makes no difference to the time test whether the activities in question **extend over more than one assessment year** (This issue is discussed in detail later).

6.2.3.1 Due to the very nature of contract, there may be relocation of project office (road contracts, dredging activity) such shifting is usually immaterial for purpose of computing construction PE as the business activities continue.

6.2.3.2 It may also be noted here that Article 5(3) overrides Article 5(1), being a special provision.

6.2.4 Issue of Composite Contracts and Determination of PE

6.2.4.1 A key issue that is disputed in the case of Project PE is the composite nature of such contracts or projects where different elements of the contract are classified separately onshore services (e.g. supervision, testing), onshore supply (e.g. supply of minor spare parts), offshore services (training outside India, design) and offshore supply (supply of plant and machinery from outside India).

6.2.4.2 At times, the non-resident assessee itself is dealing with all 4 aspects but by way of separate agreements. In other cases, it may enter into a consortium arrangement with an Indian entity, usually a related party, which deals with the onshore elements of the contract. The

assessee in both these scenarios, often claims that the offshore supply and at times even offshore services are not taxable in India as the same are rendered outside India (some assessees may offer offshore services as FTS separately on gross basis, but offshore supply is still treated by them as nontaxable).

6.2.4.3 This is one of the most widely used methods in case of project PEs in India. Thus, such a splittingup of contracts by the non-resident assessee or between closely related enterprises results in absence of the main contractor from the tax jurisdiction where the contract is being executed. Splitting may at times also result in the enterprise failing the duration test.

6.2.4.4 In all such cases it is important to go through the terms of the contracts carefully, including all related MoUs, tender documents, bid documents, amended contracts etc. It has to be determined whether the non-resident assessee either through its own presence as a Project PE or its Indian related party is assuming risks and responsibilities in India under each individual contract, which may be disproportionate to the remuneration it is receiving i.e. assuming responsibilities for offshore elements of the contract as well while receiving payments for only the onshore elements. In such cases, the possibility of the non-resident assessee having a Project PE in India for the entire contract including offshore elements needs to be examined. Most of such contracts generally have a **crossfall breach Clause** (i.e. default in one contract deemed to constitute default in the other) either embedded or provided by way of a separate umbrella agreement encompassing all contracts.

6.2.5 Involvement of Subcontractors in Project PE

6.2.5.1 At times portions of onshore contract might be subcontracted by the GE to Indian companies. These subcontracts, generally speaking, lead to payments which result in a loss situation with respect to onshore activities. However, this also gives an opportunity to examine the risks being shared with the subcontractors for carrying out the onshore activities by the PE (which under the Treaty is carrying out the onshore activities as an entity separate from the GE).

6.2.5.2 In such a scenario, it is important to examine the terms of the agreement, MoU etc. between the subcontractor and the PE carefully. The PE would initially have taken full risks and responsibilities w.r.t. the contract on behalf of the GE. Subsequently, when it has subcontracted, it should be seen whether the subcontractor is independently liable for the completion of its scope of work and related responsibilities or whether shared risks are present in subcontracted contract also. In other words, it needs to be examined if the PE is still responsible for the completion of contract, shares risks, or bears part or whole responsibilities w.r.t portion subcontracted out also. Such an analysis would assume significance if it reveals that the onshore remuneration is not comparable to the overall functions and risks of the PE.

6.3 Service PE

Service PE is also defined in **Paragraph 3 of Article 5** of the DTAA. Furnishing of services, including consultancy service, through employees or other personnel of an enterprise of one of the states constitutes PE in the state where the services are performed. Similar to Project PE, it is to be seen that these services are performed for more than specified time period (the period is different for each DTAA). The services may be provided by the presence of the personnel or employees of the non-resident enterprise.

6.4 Agency PE

6.4.1 Paragraph 5 of Article 5 specifies a person acting on behalf of the non-resident assessee as PE in India as dependent agency to be deemed as PE of the non-resident if it performs the following functions:

a. Habitually exercises **authority to conclude contracts**, or

b. Habitually maintains stock of goods or merchandise from which regular deliveries are made on behalf of the foreign enterprise, or

c. Habitually **secures orders wholly or almost wholly** for the foreign enterprise or enterprises controlled by the foreign enterprise.

As already specified, brokers, general commission agents or other agents of independent status i.e. who are acting in their regular course of business, are not counted as dependent agents. This exception is provided for in **Paragraph 7** of Article 5 of the DTAA. Again this exception would not apply in case where:

a. Activities of such persons are **devoted wholly or almost wholly** on behalf of that enterprise; and

b. Transactions between agent and the enterprises were not made at arm's length conditions.

6.4.2 As per Para 5 of Article 5, it is specified that an agent may not be treated as an agent of independent status if his activities are devoted wholly or almost wholly on behalf of the enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status.

6.4.3 Once an agent is identified as not an independent agent or a dependent agent then if he performs functions under Para 4 of Article 7, he shall be deemed to be a PE of the GE. It is noteworthy that this is a deeming provision and performance of functions as per Para 4 of Article 5 is specifically provided to be characterized as functions of a Dependent Agent Permanent Establishment ('DAPE'). Thus, an agent of dependent status whose activities are devoted to one or multiple related enterprises, will be directly covered within the scope of Para 4 of Article 5 of the DTAA.

6.4.4 The authority to conclude contracts is a much disputed issue while establishing DAPE. The assessee may claim that even if employees or personnel of Indian AE are participating in some stages of contract negotiation, they do not have an authority whether expressed or implied, to finalize a contract on their own volition (thereby denying the existence of an Agency PE). In this regard it is important to note:

a. Factual data gathered in the form of statement of key persons, emails, appraisal reports, manager assessments, might bring to light the fact that the end process i.e. final approval of a contract may be a formality whereas the meaningful negotiation phase or significant parts of it was done by LO or Indian AE and took place in India, thereby indicating the probability that there exist Agency PE in India.

b. Lack of active involvement by GE in transactions may be indicative of a grant of authority to an agent.

c. Depending upon the facts of the case, a person who is authorized to negotiate the essential elements of contract, and not necessarily all the elements, can be said to exercise the authority to conclude contracts. It might also be seen in such case if the final approval stated to be granted by GE outside India, might actually be only a routine and perfunctory approval whereas contracts were essentially being finalized by the Indian agent.

d. The nature and quantum of expenses being claimed by the Indian AE may also be examined. For instance if the GE is claiming that it is marketing its products and services from outside India without the Indian AE's involvement, but the Indian AE is claiming substantial selling and distribution expenses for selling similar products on its own, it may be indicative that the Indian AE is also performing marketing functions for the GE, without receiving commensurate compensation,

and further analysis to determine existence of Agency PE may be done.

e. Indian AE might be stating that it is performing specific functions for the GE only, but an analysis of activities performed by the Indian AEs may establish that it is in fact representing the business presence of the GE in India.

7. It is important to note that the above discussed categories and indicators of various types of PE are not watertight compartmentalized definitions, and a PE can be more than of one kind simultaneously. For instance, a project PE can also be a service PE or a fixed place PE can at the same time be a project PE. Thus all the above features can be used as indicative of whether a foreign company has a PE in India. The focus is not characterization of a PE as a single type of PE only but determination of PE in India by identification of the nature and significance of activities being carried out by the foreign company in India, the roles and responsibilities, and the functions discharged in India and the risks and obligations being assumed by the foreign company in India. Once the same is established, the **next stage is attributing profits** of the non-resident assessee to the said PE, as only profits attributable to the PE would constitute the business income of the non-resident assessee that is chargeable to tax in India. In effect, the determination of a PE is a factfinding exercise.

8. ATTRIBUTION OF PROFITS

8.1 Once a PE has been determined in India as per Article 5 of the DTAA, the issue of the extent to which the business profits should be taxed comes into picture. As per **Article 7(1)**, only so much of the profits of the non-resident assessee should be taxed in India as is attributable to the assessee's PE in India (this paragraph is common to most treaties). The UN Model Convention and some treaties e.g. the IndiaUSA DTAA, contain two additional kinds of profits of a non-resident foreign enterprise that can be taxed in India–profits attributable to sales in India of goods and merchandise of the same or similar kind as those sold through the permanent establishment, or profits attributable to other business activities carried on in India of the same or similar kind as those effected through the permanent establishment.

8.2 Again, it is important to note that profit attribution has to be done in both states i.e. state of residence and source state. This is provided for by Article 7(2) which states that *'Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in* ***each contracting state be attributed to that permanent establishment profits*** *which it might be expected to make…'*

8.2.1 Thus, only when the profit attributable to a PE is acceptable in both countries can the issue, be held to be concluded. If there is a difference in the profits attributed by the source country to the PE and the profit held to be attributable by the country of residence, the same can be resolved either through regular appellate channels or by referring the matter to MAP authorities.

8.3 Article 7(2) further specifies that the profits attributed to the PE would be such that it would be expected to make, if it was an enterprise distinct and independent from its global enterprise or non-resident assessee (GE), and engaged in activities similar to the GE. Moreover, the dealings between the PE and GE would be treated as dealings that are between independent entities. Thus in effect, the principle of transactions between associated enterprises are to be at arm's length price is brought into play for determining profits of PE.

8.3.1 To elaborate, Article 7(2) mentions that those profits should be attributed to the permanent establishment which:

a. It **might be expected** to make,

b. If it were a **distinct and separate** enterprise,

c. Engaged in the **same or similar** activities,

d. Under the **same or similar conditions,**

e. And **dealing wholly independently** with the enterprise of which it is a permanent establishment.

Thus though the PE is legally not a separate entity, distinct from GE for the purpose of attributing profits to it, it has to be deemed as such. Further, the DTAA mentions, that a PE not only has to be taken as separate entity, it has to deal with the enterprise of which it is a PE, in an independent manner.

8.4 Article 7(3) deals with the allowability of certain specific expenses separately. It specifies that in determination of the profits of a PE, expenses that are incurred for the purposes of the business of the PE shall be allowed as a deduction. By inclusion of this Clause, the treaty gives the contracting states the power to refer to the domestic legislation i.e. for determining allowable business expenses, the provisions of the Act which deal with computation of business profits must be necessarily referred to. Article 7(3) also refers to other typical expenses that are encountered in dealing with foreign companies. This includes **general and administrative expenditure** whether incurred in India or elsewhere, generally subject to limitations provided by the domestic law (if the Treaty contains such a provision).

8.5 However, no deduction shall be allowed to PE on account of royalties, fees or similar payments for use of patents and other rights etc., paid to the head office or GE. Except in cases of banks no deduction for interest payment on money lent shall be allowed. Similarly, payment by HO to PE under the above heads, will not be considered as receipts in the hands of the PE for calculating the profits of the PE (except for banks).

8.6 Article 7(4) of DTAA further provides for a situation where the customary practice of the Contracting State where the PE is located is to tax profits on apportionment basis or similar methods. Article 7(4) specifies that in such cases, notwithstanding Article 7(2), the attribution of profits to a PE determined as per Article 5, may be continued to be done by way of such apportionment. However, the method of apportionment should be such that it leads to the same result as obtained by attribution in general under Article 7(2). In certain treaties e.g. the India China DTAA, there is no Article like Article 7(4). In such cases profits may have to be computed as per Article 7(2) only.

8.6.1 Under Article 7(4), recourse has to be taken to Rule 10 of the Income-tax Rules, 1962 ('IT Rules'). In some cases for e.g. the India USA DTAA, an additional Clause is specified in Article 7(2) which is as below:

> *"…In any case where the correct amounts of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article…"*

Thus, the treaty gives specific right to estimate the profit on a reasonable basis if correct amounts of profit attribution is indeterminable. In such cases profit has to be attributed as per Rule 10 of IT Rules. However, even in the absence of this specific Clause, Article 7(2) mandates that the profit attributed should be such that the PE is expected to make if it were a distinct and separate entity from its GE engaged in same or similar activities. In case it becomes difficult to compute such profits accurately, Rule 10 may be referred to, to compute profits as per Article 7.

8.7 In the Delhi High Court decision in the case of ***Rolls Royce Singapore Pvt Ltd vs. ADIT*** **(ITA 1278/ 2010 and others)**, the issue of attribution of profits to a PE has been dealt with. In this case the assessee, a Singaporebased company, was offering receipts on account of maintenance services as part of after sales services to taxation as FTS. But, receipts on

account of supply of spares was not offered for taxation in India by the assessee on the grounds that it does not have a PE in India. However, the AO was of the view, that the assessee was discharging the contractual obligation of the supplier of the original equipment, providing maintenance services as well as making supply of spares by the assessee company was incidental to the supply of the original equipment made by another company of the Rolls Royce Group. One of the findings was that another company ANR was assessee's executive agent in India and performing these services under assessee's direction and, therefore, the assessee company had a PE in India in the form of ANR, profits attributable to which were taxed in India.

8.7.1 As regards profit attribution, in this case, it was seen that the assessee was compensating ANR at a lump sum per annum figure of USD 40,000 (in earlier years this had been fixed at 5% of invoice value). **It was held by the ITAT that this cannot be said to be at ALP, as this sort of fixation of remuneration, is not done between two independent parties in an uncontrolled transaction.** Further a profit of 10% of turnover was treated as profits attributable to PE by the ITAT (as against 25% decided by the AO).

8.7.2 On further appeal by the assessee and the Department, the Delhi High Court restored back the issue of whether there was a dependent agent PE in India as per Article 5(9) of the IndiaSingapore DTAA. However, on the issue whether ANR was already adequately compensated and there was no need for further attribution of profits, even if it is held that the assessee had a PE in India, the High Court held that from the facts **it was clear that the assessee could dictate the terms of payment by altering the same** and reducing it to USD 40,000 per annum, from 5% of invoice value as had been done earlier. This clearly led to the inference that the assessee was in a position to dictate the terms and **in the absence of any Transfer Pricing Analysis** by the Transfer Pricing Officer in the instant case, **it cannot be said that such commission could fit the description of "reasonable profits" within the meaning of Article 7(2) of the DTAA.** The High Court upheld the finding of the Tribunal in fixing 10% of the invoice value as 'profits accepted to make' for the purpose of taxation considering the above facts as well as the limited risks assumed by ANR.

8.8 In many cases, especially where a subsidiary or group company constitutes an Agency PE, the assessee may claim that even if such is the case, for functions performed in India, the Indian AE has been compensated at Arm's Length Price (ALP) and therefore, no further attribution of profits of GE can be done to the PE. In this regard it is important to note that in the case of most MNCs where a PE has been determined, the transactions would be covered by transfer pricing regime. The case may or may not be referred to TPO. However, even when it is referred to TPO, TP adjustments or the absence of such adjustments is not decisive. This is because, the transfer pricing analysis has been carried out on the basis of the functions reported to be performed by the Indian subsidiary or group company, which in most cases will not include the functions which it carries out as a PE on behalf of the GE. It is for these functions that profits are to be attributed to the agency PE (DAPE).

8.9 The above rationale has been pronounced by the Hon'ble Supreme Court in the case *of DIT vs. Morgan Stanley & Co. Inc.* (2007) 292 ITR 416 (SC). The Hon'ble Supreme Court while observing that *once a transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE as, in such cases, nothing further would be left to be attributed*, also noted an exception that '*The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.*

8.10 The Hon'ble Supreme Court has also held that when an associated enterprise, constitutes a PE, what needs to be seen is if it has been remunerated on an arm's length basis taking into account all the risktaking functions of the enterprise. If so, in such cases nothing further would be left to be attributed to the PE. Therefore, even though there exists a PE in the case, there is no further attribution of profits, as it is held that whatever revenue yielding income has been generated by the GE through functions performed by its Indian AE acting as PE, it has already been accounted for in payments made by the GE to the Indian AE. As the Indian AE is paying taxes on the income arising out of such receipts from its GE, income pertaining to activities of PE has already been accounted for, for taxation in India. However, as noted above if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the PE, further attribution of profits to the PE can be done, w.r.t. activities performed by it as GE's PE in India for which it has not been compensated or adequately compensated.

9. AVOIDANCE OF PE

Non-residents attempt to structure their business in such a way so as to avoid constitution of a PE. For instance for activities falling within the definition of Service PE, the attempt is to ensure that the duration tests are not satisfied. Splitting of contracts is another method in this regard. For other activities, assistance of local parties may be taken to ensure or give the appearance that no physical presence can be established. The tools of business allowed by internet has allowed non-residents to control their businesses remotely, thus avoiding a permanent establishment.

10. SECTION 44C *VS*. SECTION 37: THE SPECIAL CASE OF STEWARDSHIP ACTIVITIES

10.1 Section 44C of the Act provides specifically for a limit on the allowance of head office expenditure('HOE) as a deduction in the case of non-residents. Such expenditure to the maximum of five per cent of adjusted total income is allowable as a business deduction in computing profit of a non-resident taxable in India. The manner of computing adjusted total income is provided in Explanation to Section 44C. It is pertinent to note that at times non-resident taxpayers will claim a deduction for the entire head office expenditure, incurred outside India, claiming that the same is related to earning taxable business income in India. However, Section 44C limits such a claim.

10.2 The purpose of allowing this deduction of head office expenditure is giving the benefit of the expenses incurred outside India by a non-resident, for earning income in India. However, to ensure that such a claim is reasonable and not disproportionately inflated, a cap on the same is provided by way of Section 44C. An illustrative list of expenses that can be classified as 'head office expenditure' is given in Explanation to Section 44C.

10.3 The intention of introduction of Section 44C of the Act is to provide a fair method of allocation of HO expenditure. In the absence of provisions of Section 44C, the HOE cannot be allowed at all. The HOE is in the nature of general administrative expenses, which are allocated costs and hence the allowance of such expenses as deduction shall always be subject to restrictions of domestic law u/s 44C.

10.4 In some cases it is seen that over and above the claim of head office expenditure under Section 44C, assessee's also claim deduction of similar expenditure under Section 37. In view of the specific deduction under Section 44C available for head office expenditure, it needs to be examined whether the assessee is eligible for an additional claim under Section 37 of the Act. These claims many a times fall into the category of 'intragroup services' (IGS) which are provided to the group entities, including branches, by the MNE group. These form part of 3CEB documentation submitted by the branch Pes in India and are subjected to transfer pricing analysis by the TPO.

10.5 Assessee's often claim a deduction under Section 37 from their business profits taxable in India, for such expenditure incurred outside India by the head office or group enterprises, and charged to the branch PEs on allocation basis, arguing that such payments are not covered in head office expenditure as specified in Section 44C and the same is not subject to the threshold limit provided in Section 44C.

10.6 In this regard firstly, the claim of the assessee that this expenditure is not in the nature of executive and general administrative expenditure incurred outside India by the head office and not covered by Section 44C needs to be examined. The assessees in some cases rely on Explanation (iv) to Section 44C to state that such expenditure is not covered under Section 44C of the Act. However, the definition in Explanation (iv) is an inclusive definition and the list provided therein regarding the types of expenditure which will be treated as executive and general administrative expenditure is not exhaustive.

10.7 On the other hand, the allowability under Section 37 of the Act depends on fulfilment of certain conditions. It is provided therein that such expenditure should be **laid out** or **expended wholly and exclusively for the purposes of business** or profession. Thus, not only the books of accounts of the PE should reflect entries for the said allocation of expenses and carried over to the profit and loss account ('laid out'), but it should be expended 'wholly and exclusively' for the purposes of business of the PE in India.

10.8 In the case of ***Dhimant H. Thakkar vs. CIT*** **B.C.II** (Income-tax Reference No. 487 of 1997; date of order 28 October, 2015), **Hon'ble Bombay High Court** had occasion to consider the expression "*wholly and exclusively*" as used in Section 37(1) of the Act. Reference to the decisions of **Hon'ble Supreme Court** in the case of *Sasoon J. David & Co. Pvt. Ltd vs. Commissioner of Income-tax (Bombay)* (118 ITR 281), *Eastern Investments Ltd vs. Commissioner of Income-tax West Bengal* 20 ITR and an unreported decision of Hon'ble Bombay High Court in Commissioner of Income-tax v/s. NGL Network (I) Pvt. Ltd. (Income-tax Appeal No.538 of 2012) was made before the Hon'ble Court. Hon'ble High Court, after examining the matter, have mentioned the following in this regard:

> *"However, in all the above cases, persons other than the assessee who incurred the expenditure also benefited. In the above context, it was held that where such expenditure is incurred for the purposes of the business and some third party gets* ***incidental benefit****, the expenditure under Section 37(1)* of the Act cannot be disallowed."

Hon'ble High Court then laid down the principle that, if it is found that it is the assessee who is getting **incidental benefit**, then it cannot be said that the expenditure was wholly or exclusively for the purposes of its business (para 15 of the order). This principle also emerges from the decisions of Hon'ble Supreme Court mentioned above, where benefit was arising to other parties also, but the benefit to parties other than the assessee was incidental in nature, and not otherwise.

10.9 Thus, when benefit, if any, arising to the India operations is only incidental, then expenditure made for availing such services cannot be said to be wholly and exclusively for the purpose of business within the meaning of Section 37 of the Act. Therefore, in such situations, expenditure which is incurred by the head office or group enterprises outside India and allocated to the PE is not an allowable deduction under Section 37.

10.10 Moreover, Section 37 also mandates that the expenditure claimed by the assessee for the purposes of computing its income from business, has to be laid out, or expended wholly and exclusively. Thus, the expenditure should be debited in the books of the PE and carried to the profit and loss account of the PE.

10.11 In the case *CIT, Delhi vs. Delhi Safe Deposit Co. Ltd.*, (AIR 1982 SC 757), Hon'ble Supreme Court considered various decisions of the English Courts in construing as to what would be "wholly and exclusively" for the purpose of business or profession. Hon'ble Apex Court have observed thus in this regard:

> *"Dealing with the question whether an expenditure incurred by a brewery in aid of their tenants of tied houses as a necessary incident of the profitable working of the brewery business was an admissible expenditure in the computation of the incometax liability of the brewery, Lord Summer upholding the above claim observed in Usher's Wiltshire Brewery Ltd. vs. Bruce thus*:
>
> > "*Where the whole and exclusive purpose of the expenditure is the purpose of the expender's trade, and the object which the expenditure serves is the same, the mere fact that to some extent the expenditure enures to a third party's benefit, say that of the publican, or that the brewer incidentally obtains some advantage, say in his character of landlord cannot in law defeat the effect of the finding as to the whole and exclusive purpose."*

Thus, the meaning of the expression 'wholly and exclusively', where benefits also endures to third parties, is that such a benefit should be of incidental nature only, and the main or primary beneficiary should be the assessee. **Where the assessee's benefit itself is not primary, but secondary to other parties' benefit, then the test of 'wholly and exclusively' for the purposes of business would fail.**

10.12 This leads to the question as to ***who is the primary beneficiary in case of the services where charges have been allocated to the assessee***. The answer to this question depends on the nature of these services. If the services are of the nature of '***stewardship activities'*** then the benefit to the assessee would not be of primary nature but secondary only. In this regard, reference is made to the decision of Hon'ble Supreme Court of India in the case of *M/s DIT (International Taxation), Mumbai vs. Morgan Stanley & Co., Inc*, in Appeal (civil) 2914 of 2007 reported in (2007) 292 ITR 416 (SC). The salient features of this decision are being highlighted in the paragraphs that follow.

10.12.1 The matter had arisen before the Hon'ble Court on the basis of an SLP filed by both the Revenue and the applicant (who had applied for the Ruling) with reference to the Ruling given by Hon'ble Authority for Advance Ruling in the case of ***In Re: Morgan Stanley and Co. vs. Unknown*** on 13 February, 2006.

10.12.2 In the matter before Hon'ble AAR, the applicant was M/s Morgan Stanley & Co., US, a non-resident company incorporated in the United States of America (USA) under the General Corporate Law of the State of Delaware and a tax resident of USA. It was a whollyowned subsidiary of Morgan Stanley, US which is a leading investment Bank having a number of group companies in various parts of the world. The applicant, inter alia, provided financial advisory services, corporate lending and securities underwriting. The diverse activities of the applicant were undertaken by various divisions. One of the group companies was Morgan Stanley Advantage Services (P) Ltd. ("MSAS") which was incorporated in India and was setup by the Morgan Stanley Group to support the Group Member's front office and infrastructure unit functions in their global operations for providing support services.

10.12.3 The applicant proposed to send its staff to India for **stewardship activities and other similar activities to ensure that the high standards of quality are met as Morgan Stanley group entities are to be satisfied that the services received by them from other group view of the first proviso to Subsection (2) companies**

meet the Morgan Stanley standards. These stewardship and certain other similar activities such as:

a. Briefing MSAS on the standard of services expected,

b. Acquainting the staff on various aspects of the functions by conducting briefing sessions for effective transitioning of various functions, and

c. Providing basic guidance;

Were required to be undertaken **so that services to be provided by the Indian subsidiary would meet the overall global value benchmarks of the Morgan Stanley Group**. The stewardship activities included monitoring the overall outsourcing operations at MSAS. (Para 1 of the Ruling, with emphasis supplied)

10.12.4 Hon'ble AAR ruled in the following manner in this case on the questions pressed for a Ruling (question wise):

1(a). *That MSAS is not the PE of the applicant in India under the provisions of Article 5(1) of the Treaty;*

1(b). *That MSAS would not constitute an agency PE of the applicant under Article 5(4) of the Treaty;*

1(c). *That MSAS would be regarded as the PE of the applicant in India under Article 5(2)(1) of the Treaty if it were to send some of its employees to India for undertaking stewardship activities as described in para 3 in Annex. II for a period beyond ninety days;*

1(d). *That MSAS would be regarded as the PE of the applicant in India under Article 5(2)(1) of the Treaty, if it were to send some of its employees to India on deputation in the employment of MSAS for a period beyond ninety days;*

2. *That the question is liable to be rejected in view of the first proviso to SubSection (2) of Section 245R of the Act;*

3. *That as this question is dropped, we decline to pronounce any ruling on it.*

4. *That based on the facts and circumstances of the case, as long as MSAS, being the PE of the applicant in India, is remunerated for its services at arm's length by the applicant/Morgan group and as long as all its actual income is brought to tax, no further income can be attributed in the hands of the PE of the applicant.*

5. *That as the first part of the question which is consequential to question Nos. 1(c) and (d) is the premise for the second part which is in fact the real question and is nothing but an alternate formulation of question Nos. (2) and (3); in as much as question No. (2) is rejected and question No. (3) is dropped, no ruling need be given on this question."*

10.12.5 Both, the DIT (International Taxation), Mumbai and the applicant M/s Morgan Stanley & Co, Inc filed petitions before the Apex Court against the Ruling given by Hon'ble AAR. With regard to services, Hon'ble Court considered the following question for determination (para 13 of the order):

"13. However, the question which arises for determination in the present case is the nature of activities performed by stewards and deputationists deployed by MSCo to work in India as employees of MSAS. Under Article 5(2)(l) furnishing of services through the fixed place in India can constitute a P.E. The AAR in the impugned ruling has held that the stewards and deputationists are proposed to be sent by the MSCo from U.S. According to the AAR there is a flow of service from the MSCo to the MSAS when the former deputes its own employees to work in India in MSAS. ***Therefore, according to the AAR the service Agreement between MSCo and MSAS dated 14.4.2005 would fall under Article 5(2)(l) and consequently the transfer***

pricing regulation would apply for evaluating the charges payable by MSCo to MSAS in India for such service contract*. This ruling has been challenged by the applicant." (emphasis supplied)*

10.12.6 Hon'ble Supreme Court, segregated the services under two heads–'stewardship services' and 'services performed by deputationists'. With regard to stewardship activities, Hon'ble Court held the following (para 14 of the order):

> "*14. Article 5(2)(l) of the DTAA applies in cases* ***where the MNE furnishes services*** *within India and those services are furnished through its employees. In the present case we are concerned with two activities namely stewardship activities and the work to be performed by deputationists in India as employees of MSAS. A customer like an* ***MSCowho has world wide operations is entitled to insist on quality control and confidentiality*** *from the service provider. For example in the case of software P.E. a server stores the data which may require confidentiality.* ***A service provider may also be required to act according to the quality control specifications imposed by its customer****. It may be required to maintain confidentiality.* ***Stewardship activities involve briefing of the MSAS staff to ensure that the output meets the requirements of the MSCo. These activities include monitoring of the outsourcing operations at MSAS. The object is to protect the interest of the MSCo.*** *These stewards are not involved in day to day management or in any specific services to be undertaken by MSAS.* ***The stewardship activity is basically to protect the interest of the customer.*** *In the present case as held hereinabove the MSAS is a service P.E. It is in a sense a service provider. A customer is entitled to protect its interest* ***both*** *in terms of confidentiality and in terms of quality control.* ***In such a case it cannot be said that MSCo has been rendering the services to MSAS. In our view MSCo is merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services. We do not agree with the ruling of the AAR that the stewardship activity would fall under Article 5(2)(l).*** *To this extent we find merit in the civil appeal filed by the appellant (MSCo) and accordingly its appeal to that extent stands partly allowed*." (emphasis supplied)

10.12.7 Thus, in the view of Hon'ble Supreme Court of India, stewardship activities do not constitute services and thus there cannot be any charge for them. It needs to be stressed that this view has been taken in a case where there was visit of personnel from US to India. Thus, in a case where the services of this type are rendered from outside and cost is computed on an indirect basis, there cannot be even a remote possibility of arriving at a charge for such services. Such stewardship activities, on the basis of the decision of the Hon'ble Apex Court, are described as constituting of:

Description	Nature of Service
Requirements and procedures to maintain confidentiality on account of worldwide operations	Stewardship activity
Requiring the subsidiary/related entity to act according to the quality control specifications	do
Briefing of the staff of the subsidiary/related entity to ensure that the output meets the requirements of the parent company/group	do
Overall monitoring of the operations of the subsidiary/related entity (other than daytoday management)	do
Protecting the interest of the parent company in a competitive world	do

10.12.8 International commentators have Recognised that in the Morgan Stanley case, Hon'ble Supreme Court of India have taken the same view about stewardship activities which was prevalent in the US from 1968 onwards with regard to determination of an arm's length charge for such services. Thus, Jens Wittendorff has mentioned in his book ('*Transfer Pricing and the Arm's Length Principle in International Tax Law*', Vol.35 in 'Series on International Taxation', Kluwer Law International, 2010; page 484) that, **"The definition of services applied by the Supreme Court in regard to stewardship activities corresponds to that applied by the US Courts on the basis of the Section 482 regulations from 1968, in which the concept of 'stewardship functions' was the focal point"**. Thus, to have a broad view about what constitutes this 'stewardship function', reference needs to be made to US case law, especially to the decision in the oft quoted case of *Young & Rubicam vs. United States*.

10.12.9 In the case of ***Young & Rubicam vs. United States,* 410 F.2D 1233** (Ct.Cl. 1969) a US parent company had assigned employees to various foreign subsidiaries and the IRS, invoking Section 482 (the Section pertaining to determination of an arm's length price, i.e. the US transfer pricing regulations) had charged the parent company tax on imputed income from management and administrative services deemed to be performed for the subsidiaries. The Court of Claims examined the services performed by the personnel of the parent company in the following manner:

> "**80. The Commissioner may allocate costs or deduction to properly reflect managerial, administrative or other services performed by one member of a group for another member. Allocation is an attempt to reflect the true income of related companies as if the services had been performed by an unrelated entity.** *See, Eli Lilly & Co. vs. United States*, 372 F.2d ,990 178 Ct.Cl. 1967) 666); and *Oil Base, Inc. vs. Commissioner of Internal Revenue*, 362 F.2d 9) 212th Cir. 1966), cert. denied, 385 U.S. 87 ,928 S.Ct. ,287 17 L.Ed.2d 211. **The Commissioner allocated income to plaintiff to measure the value of the managerial services it purportedly performed for the subsidiaries through four individuals—Messers. Wilkerson, Hagen, Penn and Hardy.** Unlike the 21 individuals involved in Section I of this opinion, they were not assigned to continuous duty abroad with a particular subsidiary, and we are not faced with the question of the deductibility of their salaries. **The fact question is whether they performed general supervisory services for plaintiff or they performed managerial services for a subsidiary for which the subsidiary would have paid a fee had they been performed by an unrelated corporation. Our conclusion is that the activities proved were general supervision for plaintiff and that no support exists in this record for the allocation. Supervisory functions such as these are not subject to allocation under Section 482.**
>
> **81. Many of these activities benefitted the subsidiaries, but we are concerned with whether the functions performed were supervisory controls for plaintiff or specific management services for a subsidiary. The nature of these activities, as reflected in the record and relied on by defendant, are summarized as follows:**
>
> **82.** Wilkerson was a senior vice-president of plaintiff and head of its International Division from January 1 through April 19, 1960. The International Division was responsible for the general supervision of subsidiary corporations and promoting additional foreign expansion. Wilkerson

was directly responsible to plaintiff's president and its Board of Directors.

83. In 1959, plaintiff received complaints that the Creative and Research Departments of its German office were not developing satisfactory material. General Foods had threatened to terminate its relationship with the German subsidiary. Wilkerson traveled to Frankfurt when Gaudier replaced Nussbaum as managing director and met with representatives of the subsidiary's clients. He had represented General Foods as plaintiff's client and had substantial contacts with personnel in the General Foods headquarters in New York. He made several trips to Frankfurt, and eventually the problem was solved.

84. In January 1960 he went to Puerto Rico when Brandi replaced Austin as general manager and installed DeVos as assistant manager. Again he visited with some of the subsidiary's clients. There is no indication that either his activities in Frankfurt or Puerto Rico were management services, rather they were an attempt to exert some "onthespot" supervision.

85. Lyon had been sent to Toronto to correct a particular problem with the Whitehall Laboratories Ltd. account and, in April 1960, Wilkerson traveled to Toronto to discuss the problem. He also made several trips to London.

86. During 1960 he made several new business presentations to companies interested in marketing their products internationally. One of his general functions as head of the International Division was to encourage companies to hire all of plaintiff's subsidiaries as their representatives for particular markets.

87. On the basis of this record, we conclude that his activities were in the nature of supervisory controls or other general activities for plaintiff and not management services for the business of a particular subsidiary.

88. Hagen was a vicepresident in charge of Western Hemisphere corporations. He reported to Wilkerson until April, 1960 and thereafter to the plaintiff's president. His responsibility was to make certain that the various offices maintained plaintiff's production standards and that the subsidiaries performed their duties to their clients' satisfaction. He frequently traveled to the offices of a subsidiary's clients to hear complaints and accept general comments on the activities of a particular subsidiary.

89. In 1960, plaintiff decided to consolidate its Montreal and Toronto offices and Hagen traveled to Toronto to solve any personnel problems that might arise in connection with the consolidation. He also made three trips to Mexico City to discuss general problems with Vaamonde and his replacement Martinez. He also made one trip to Caracas. **Again, the record proves that these were general supervisory activities which assisted plaintiff in its attempt to control the activities of its subsidiaries**.

90. Penn had been a partner in the PennZerbe advertising agency which plaintiff acquired in 1956. He became a managing director of New York International Services and during 1960 traveled to San Juan together with Wilkerson when DeVos replaced Austin as managing director. He attended presentations by San Juan personnel to their clients. He made five trips to Caracas and met with Young & Rubicam de Venezuela's clients together with personnel from the subsidiary. He also

made one trip to Mexico City. There is no proof of the specific managerial services which defendant alleges he performed for the subsidiaries.

91. Hardy was an account executive assigned to New York International Services from February 16 to October 9. On May 16, he traveled to Caracas where he remained until June 20. He managed the office when Martinez traveled to the United States. Later in the year he went to Venezuela.

92. He also traveled to Mexico City together with representatives of clients to meet with Vaamonde and solved several problems that had developed. This was part of a general circuit trip to other parts of Central and South America. His activities were also supervisory.

93. We think that the above summary shows that the activities relied on by defendant to support the Commissioner's allocation were part of plaintiff's attempt to control its subsidiaries, their personnel and offices. There is no evidence that these four individuals performed specific managerial services for specific subsidiaries, and therefore we must conclude that the allocation is not supported by the record and that the Commissioner's allocation was improper."

10.12.10 It would be useful to list out these **supervisory or stewardship activities**, for which the recipients should not have been charged even when they benefitted from the services (cf: para 81 of the Order):

Reference	Service Details	Remarks
Para 83	Seeing to it that the subsidiary (service recipient) develops materials to the satisfaction of clients (in other words, seeing to it that the subsidiary produces or makes or provides goods or services which are up to the standards expected of the parent)	Service not managerial but supervisory control or stewardship
Para 84	Visiting the subsidiary's clients; onthespot supervision	do
Para 86	Making presentations for getting new business; getting third parties to give business to subsidiaries in particular markets	do
Para 88	to make certain that the various offices maintained plaintiff's production standards and that the subsidiaries performed their duties to their clients' satisfaction.	do
Para 89	Deciding to consolidate foreign offices; travelling to such offices to solve personnel problems;	General supervisory services in attempt to control activities of subsidiaries.

10.12.11 This test is generally referred to as the '**direct and proximate benefit**' test. It is similar to the incidental benefit test applied by the English Courts while determining whether an expense item complied with the '**wholly and exclusively for the purposes of business**' test. In other words, if the service provides 'direct and proximate benefit' to the service provider, there should not be a charge on the party which is receiving (1) indirect benefit or (2) whose benefit is incidental. Both these principles have been applied by Hon'ble Supreme Court of India in the decisions mentioned above. Thus, if the services constitute stewardship activity, then the benefit to the assessee cannot be held to be primary, but secondary and incidental only.

10.12.12 Further, based on other decisions of the US Courts on stewardship activity, where the so called **'direct and proximate benefit test'** has been applied, the following services will also

need to be included to give effect to the decision of the Hon'ble Supreme Court of India in the Morgan Stanley case cited above:

Service Type	Reference
Diligent efforts to provide the subsidiary with the highest feasible sales revenues, including shutting down a U.S. plant in order to keep the subsidiary in production; The establishment of artificial and unreasonably high prices to help the subsidiary in production; and The provision of personnel who served as members of the board of directors and officers of the subsidiary	*Merck & Co. vs. United States*, 24 Cl.Ct. 73 (1991)
Audits by the parent, Reporting requirements of the parent, Reviewing of contracts by the parent, Providing for consistency of accounting systems etc Business development activities	*H Group Holding Inc. vs. Commissioner, TCM* 1999–334 (1999)

10.13 If it is found on analysis of the evidence submitted by the assessee regarding the services for which costs have been allocated to it, that these **are of the same type which provide proximate benefit to the Group or Group Parent entity and not to the assessee (branch/office or PE in India) and hence the services do not provide primary benefit to the assessee and fall under the category of 'stewardship activity' for which there should not have been any charge on it, then the expenses cannot be allowed under Section 37 of the Act**. In other words, if the services received by the assessee are of the nature of 'stewardship activity' of the MNC as a Group, and the direct and proximate benefit is to the Group and not to the assessee's PE in India in the form of its offices in India**, the benefit to the PE in India is incidental and not primary. Hence, the expenditure cannot be held as being '*wholly and exclusively*' for the business of the PE of the assessee in India.**

10.14 It also needs to be remembered that such a disallowance is completely separate from the adjustment to arm's length price determined by the TPO in case of the international transactions reflected in Form 3CEB. If the TPO has also held that these services are in the nature of stewardship activities, the disallowance under Section 37 of the Act should be mentioned in the order, and only the adjustment made in the TP Order should be added to the income, with the Section 37 disallowance surviving the outcome of appellate proceedings as a separate disallowance. If the adjustment to arm's length price is less than the Section 37 disallowance, the balance amount should be added to total income, with again the Section 37 disallowance surviving the outcome of appellate proceedings as a separate disallowance.

11. The time of PE coming into existence– the assessment year in which it comes into existence taxation of receipts after a PE ceases to exist:

11.1 A key issue, that comes up for consideration while examining if the duration test is satisfied in cases of PE, is whether the timethreshold to be satisfied e.g. 6 months for a Project PE, has to be satisfied for each Assessment Year separately. In other words, to declare that a project PE is in existence in a particular assessment year, the issues arises as to whether it should be in existence for a period exceeding 6 months in that year or once the PE is in existence for more than 6 months (irrespective of whether it happens exclusively in one year or across

multiple Assessment Years) then the duration test remains satisfied till PE is in existence.

11.2 The concept of a permanent establishment has a long history. The temporal aspects of the existence of a PE visàvis its existence in a calendar or assessment year, and taxation of income received after the closure or liquidation of the PE are more or less well settled in international tax law.

11.3 Dr. Klaus Vogel, in his seminal work 'Klaus Vogel on Double Taxation Conventions' (3rd edition) has stated at M. No. 76 on Article 5 of the OECD MC that,

> "According to OECD MC and US MC, the minimum length of time a building site or construction or installation project must last in order to constitute a permanent establishment is 12 months. If it lasts for more than 12 months, the permanent establishment, rather than beginning to exist at that point of time, is deemed to have existed from the very outset. … **It makes no difference to the time test whether the activities in question extend over more than one calendar year or one assessment period. If part of the period were to be in one year, and the remainder in the next, this would not prevent a permanent establishment from coming into existence**." (emphasis added)

From the above, it is clear that the DTAA does not require the time test to be fulfilled in each and every assessment year–once the PE comes into existence after fulfilling the condition of existence for more than six months under Article 5(2)(i), it will continue to exist in all the assessment years where its existence overlaps, up to the date of completion of its contract. Thus, if a sixmonth test is provided in any DTAA entered into by India, then it does not matter that the PE exists in a particular assessment year for less than six months. The duration test is applied to the PE as a whole and if the PE per se fulfils the conditions, then it will be regarded as continuing to exist even in the assessment year in which its existence was for less than six months.

11.4 With regard to taxation of amounts received after the permanent establishment has ceased to exist as well, international tax law appears to be well settled. Dr. Klaus Vogel has mentioned in the same work at M. No. 6 pertaining to 'Preface to Articles 6 to 22' that,

> "In connection with the application of distributive rules, particular problems are apt to arise whenever items of income are received during a period other than the one in which they accrued (**advance income, subsequent income**). Rather than looking at whether or not the requirements of the distributive rule had already been, or were still being satisfied at the time when the items of income were received, the decisive point is to determine the time when the income was 'earned', *viz.* when whatever **decisively caused** the income to accrue, actually occurred."

Dr. Vogel has further elaborated the above at M. No. 34 pertaining to Article 7 of OECD MC by stating that,

> "The permanent establishment must have existed at the time when whatever **decisively caused** the profits to accrue, actually occurred. If this is so, the State of the permanent establishment is entitled to impose tax, even if the profits did not accrue until after the permanent establishment had been liquidated …".

Thus, if the receipts have accrued and arisen on account of activities undertaken by the PE when it was in existence, then the receipts are taxable even after the PE has ceased to exist.

11.5 In some cases, where specific treaty provides for it, 'force of attraction' rule can be invoked to tax receipts related to a PE even when PE does not exist in that year. In other words, if separate PEs exist during any assessment year, the revenues can be considered for taxation

even if the time test in case of some projects is not fulfilled. However, in general, unless the DTAA specifically allows to do so (for example, the India USA DTAA, Article 7(1)) such limited 'force of attraction' principle cannot be applied to PEs. This is because in treaty law, each PE is to be considered as a separate PE (reference, Klaus Vogel, ibid; Article 5, M. No. 79: **The question whether there is a permanent establishment in a specific contracting State or not should be considered separately for each business activity performed in that State, i.e. for each individual place of business existing there as well**.")

11.6 However, irrespective of whether force of attraction rule is embedded in a treaty or not, the main issue in all cases where income is received after a PE ceases to exist, is that income is brought to tax in a particular tax period on the basis of the Domestic Law (in the case of India, the Income-tax Act, 1961) and the DTAA is for providing relief. The DTAA does not and cannot subject any receipt to charge of tax if it cannot be done so under the domestic law.

11.7 Dr. Klaus Vogel has mentioned in this regard (ibid; Introduction, M. No. 26) that:

> "States levy taxes, however, only on the basis of their own tax laws. … **Tax treaty rules** assume that both contracting States tax according to their own law; unlike the rules of private international law, therefore, treaty rules do not lead to the application of foreign law. Rather, treaty rules, to secure the avoidance of double taxation, **limit** the **content** of the tax law of both contracting States; in other words, the legal consequences derived from them **alter** domestic law, either by excluding application of provisions of domestic tax law where it otherwise would apply, or by obliging one or both States to allow a credit against their domestic tax law for taxes paid in the other State. Within the scope of a treaty, therefore, a tax obligation exists only if and to the extent that, in addition to the requirements of domestic law, the treaty requirements also are satisfied.

Again (ibid; Introduction, M. No. 45b) he mentions that:

> "Further, treaty rules neither authorize, nor 'allocate' jurisdiction to tax to the contracting States."

He again emphasizes that (ibid; Introduction, M. No. 46):

> "**In contrast, a tax treaty neither generates a tax claim that does not otherwise exist under domestic law nor expands the scope or alter the type of an existing claim** …"

11.8 Thus, the taxation of the receipts of a PE which were received after its closure have to first be taxable under a specific provision of the Income-tax Act, 1961 and then only the question will arise as to whether the receipts are still taxable under the DTAA also.

11.9 The building, construction, installation or supervisory permanent establishment is in the nature of a business entity in India, deemed to come into existence under the force of a specific Article of the DTAA. Under Article 7 of the DTAA, it has to be treated as a separate enterprise for attribution of profits. Once the PE ceases to exist, the business entity, which was deemed into existence in India, also ceases to operate for the purpose of taxation of business profits. Thus, the receipts of this discontinued or closed enterprise should be taxable under a specific provision of the Income-tax Act, 1961 and then it should be seen whether the treaty restricts its taxation or not.

11.10 The Income-tax Act, 1961 contains specific provisions with regard to 'discontinuance of business, or dissolution'. These are contained in Chapter XV (L) of the Act. Section 176(3A) of the Act mentions the following in this regard:

"Where any business is discontinued in any year, any sum received after the discontinuance shall be deemed to be the income of the recipient and charged to tax accordingly in the year of receipt, if such sum would have been included in the total income of the person who carried on the business had such sum been received before such discontinuance."

11.11 Thus, the discontinuance of a PE is to be construed as the discontinuance of a business in India and the sum received by the assessee after discontinuance of its PE in India but which pertain to the activities of the PE in India during its existence are to be taxed as income of the assessee in India arising to its PE in the assessment year in which they were received.

11.12 It also needs to be kept in mind that the treaty practice in this regard has evolved in a particular manner much to the insistence on this in the treaties signed by the USA. Thus, Clause III to the Protocol to the IndiaUSA DTAA mentions the following:

"AD ARTICLES 7, 10, 11, 12, 15 and 23 **It is understood that for the implementation of paragraphs 1 and 2 of Article 7 (Business Profits) …, any income attributable to a permanent establishment or fixed base during its existence is taxable in the Contracting State in which such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.**"

11.13 This Clause in the Protocol is repeated in all the treaties entered into by the USA. Thus, the USA has clearly insisted on expressing in words what has remained unspoken but implied in principle in other treaties. However, for the issue at hand, the significance of citing the protocol lies in the explanation provided for this in the 'Technical Explanation of the Convention and Protocol' issued by the US Treasury with regard to the IndiaUSA DTC. This Technical Explanation mentions under Article 7 the following:

*"This Protocol paragraph **incorporates the principle of Code Section 864(c)(6) into the Convention**. Like the Code Section on which it is based, Paragraph III of the protocol provides that any income or gain attributable to a permanent establishment (or, in the context of Articles 10, 11, 12, 15, and 23, a fixed base as well) during its existence is taxable in the Contracting State where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) no longer exists."*

11.14 Thus, it is clearly mentioned in the Technical Explanation (which is meant for the US IRS) that the protocol simply follows the principle put in place in the IRS Code Section 864(c)(6), i.e. the US domestic tax law. Thus the receipts are taxed as per the US domestic legislation and only once a receipt comes within the ambit of tax as per the US domestic taxation law, will the issue of application of treaty arise. It would be pertinent here to look into the provisions of the particular Section in the US Code referred to in the Technical Explanation specified above:

"(6) Treatment of certain deferred payments, etc.

For purposes of this title, in the case of any income or gain of a non-resident alien individual or a foreign corporation which:

(A) is taken into account for any taxable year, but

(B) is attributable to a sale or exchange of property or the performance of services (or any other transaction) in any other taxable year,

the determination of whether such income or gain is taxable under Section 871(b) or 882 (as the case may be) shall be made as if such income or gain were taken into account in such other taxable year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year referred to in subparagraph (A)."

11.15 It is evident from the above, that it is based on this specific provision of the domestic law the treaties entered into by USA have their specific Clause III in their Protocol. Similarly, only once a receipt is taxable as per the Indian Income-tax Act, will the issue of taxing the same come into the picture. It is the cardinal principle of treaty law, that a receipt that is not taxable as per the domestic tax law, will not be taxed by way of treaty. The above provision taxing income received after a business has ceased to exist in the domestic tax law of USA is similar in nature to the provisions contained in Section 176(3A) of the Income-tax Act, 1961–the Indian domestic tax law.

11.16 Accordingly, first Section 176(3A) of the Act is required to be invoked to tax the receipts of a PE after its closure in the previous year of receipt. The DTAAs do not limit such taxation–as has been shown in treaty practice and law.

12. SOME IMPORTANT JUDICIAL DECISIONS

12.1 Formula One World Championship Limited

12.1.1 The case of Formula One World Championship Limited [2017] TS161SC2017 is a landmark judgement regarding the satisfaction of **duration test in the case of a** PE. It was held in the same, that short duration activities can constitute a PE depending upon the recurrence of the activities and nature of business of the assessee.

12.1.2 Facts of the Case

12.1.2.1 The assesse, Formula One World Championship Ltd ('FOWC') is a tax resident of UK. Consequent to agreements entered into between the Federation International Automobile ('FIA' an international motor sports events regulating association), Formula One Asset Management Limited (FOAM) and FOWC, FOAM licensed all commercial rights in the FIA Formula One World Championship (Championship) to the assessee FOWC for 100 year term effective from 112011.

12.1.2.2 The assessee entered into a Race Promotion Contract (RPC) by which it granted to Jaypee Sports the right to host, stage and promote Formula One (F1) Grand Prix of India event for a consideration of USD 40 million. An Artworks license Agreement contemplated in RPC was also entered into between assessee and Jaypee the same day permitting the use of certain marks and intellectual property belonging to assessee for a consideration of USD 1 million.

12.1.2.3 The assessee and Jaypee both approached the AAR and sought advance ruling on the following questions:

a. *Whether the payment of consideration receivable by FOWC(assessee) in terms of the said RPC from Jaypee was or was not royalty as defined in Article 13 of IndoUK DTAA?*

b. *Whether FOWC (assessee) was having any permanent establishment (PE) in India in terms of Article 5 of the DTAA?*

c. *Whether any part of the consideration received or receivable by FOWC(assessee) from Jaypee outside India was subject to tax at source under Section 195 of the Indian Income-tax Act, 1961?*

12.1.3 AAR Ruling

The AAR concluded that firstly the amounts paid were taxable as 'royalty'. Secondly, the AAR held that assessee had no fixed place of

business, was not doing any business activity in India and had not authorized any organisation or entity to conclude contracts on their behalf and, therefore, had no PE in India. On the issue of deduction of tax at source under Section 195, the AAR held that as the receipts are held taxable as royalty, corresponding TDS should be deducted by Jaypee on payments made to the assessee.

12.1.4 Decision of Hon'ble High Court

The assessee and Jaypee appealed against the decision of the AAR in holding the payment as royalty. The Revenue also filed further appeal arguing that the assessee had a PE in India. The Delhi High Court reversed the findings of AAR on both the issues. It held that the amount paid/payable under RPC by Jaypee to assessee would not be treated as royalty. Further, as per High Court assessee had PE in India and, therefore, the profits attributable to the same were taxable in India. The High Court has also held that Jaypee is bound to make appropriate deductions from the amount payable to assessee under Section 195.

12.1.5 Decision of Hon'ble Supreme Court

12.1.5.1 Further appeal was filed to the Supreme Court by the assessee and Jaypee, in which they contended that no tax was payable in India on the consideration paid under RPC, as it was neither royalty nor did the assessee had any PE in India.

12.1.5.2 The Supreme Court ruled that F1 event conducted in India was a virtual projection of the taxpayer on the Indian soil. Further, on the basis of findings and legal provisions, SC ruled that the taxpayer had a fixed place of business in the form of physical location, i.e. Circuit, which was at the disposal of the taxpayer through which it conducted business. Therefore, the assessee had a PE in India and the profits attributable to the same were taxable in India.

12.1.5.3 Following are the **key takeaways of the ruling**:

a. SC noted that as per Article 5 of the DTAA, the PE has to be a fixed place of business 'through' which business of an enterprise is wholly or partly carried on. SC held that the **international circuit is a fixed place** and since races are conducted from this circuit, it is an **economic/business activity.**

b. To examine whether international circuit was put at the disposal of assessee and whether it was a fixed place of business of assessee, SC referred to the arrangement between assesse and its affiliates. SC held that **various agreements cannot be looked into by isolating them from each other** and their **wholesome reading was necessary to bring out the real transaction between the parties.** Such an approach is essentially required to find out as to who is having real and dominant control over the Event.

c. SC held that the various arrangements entered into between the taxpayer and its affiliates demonstrated that the entire event i.e. media, title sponsorship and paddock rights were taken over and controlled by the taxpayer and its affiliates. SC stated that even the physical control of the circuit was with taxpayer and its affiliates from the inception, i.e. inclusion of event in a circuit till the conclusion of the event. SC remarked that "Omnipresence of FOWC and its stamp over the event is loud, clear and firm."

d. Regarding the **duration of the event** to determine permanency, it was held that the **activity was in the nature of shifting** and the **access granted to the taxpayer for 2 weeks was sufficient for creating a PE.** SC clarified that "The question of the PE has to be examined keeping in mind that the aforesaid race was to be conducted only for three days in

a year and **for the entire period of race the control was with FOWC**."

e. Accordingly, SC concluded that the taxable event had taken place in India and non-resident taxpayer was liable to pay tax in India on the income it has earned on this soil. SC held that since payments made by Jaypee to the taxpayer under the RPC were business income of the taxpayer through PE at the Buddha International Circuit, and, therefore, chargeable to tax, Jaypee was bound to make appropriate deductions from the amounts paid u/s. 195 of the Act.

12.1.5.4 The Supreme Court also made the following observations:

a. If a non-resident has a permanent establishment in India, then business connection in India stands established.

b. In Para 30 of its order, relying on the commentary of Philips Baker, the Supreme Court has listed an illustrative list of PE's:

(i) A shed which has been rented for 13 years for storing and preparing hides.

(ii) A writer's study.

(iii) A stand at a trade fair, occupied regularly for three weeks a year, through which the enterprise obtained contracts for a significant part of its annual sales.

(iv) A temporary restaurant operated in a mirror tent at a Dutch flower show for a period of seven months.

(v) An office, workshop and storeroom for the maintenance of aircraft.

c. The principal test in order to ascertain as to whether an establishment has a fixed place of business or not, is that such physically located premises have to be 'at the disposal' of the enterprise.

d. It is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise.

e. It is clarified that a place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. A certain amount of space at the disposal of the enterprise which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is required. (Para 34, while discussing OECD Commentary)

12.2 *Sedco Forex International Inc vs. CIT*

12.2.1 Taxation of certain specific receipts under Section 44BB has always been a matter of dispute between the Revenue and the taxpayer. The Supreme Court in a recent decision dated 30.10.2017 in the case of ***Sedco Forex International Inc vs. CIT and others*** **(Civil Appeal No. 4906 of 2010** and others), has held that the mobilization fees received for transportation of rigs for providing services and facilities in connection with the extraction of mineral oil in India are taxable under Section 44BB of the Act.

12.2.2 Facts of the Case

12.2.2.1 The taxpayer, a non-resident company was engaged in executing contracts all over the world including India for providing services and facilities in connection with exploration and production of mineral oil. The provisions of Section 44BB of the Act are applicable to non-resident taxpayers engaged in the business of providing services and facilities in connection with exploration etc. of mineral oil.

12.2.2.2 The taxpayer entered into contracts primarily with Oil and Natural Gas Commission (ONGC) for hire of their rig for providing services and facilities in connection with exploration

activities in India. The aforesaid agreements provided for the scope of work along with separate consideration for the work undertaken.

12.2.2.3 During the year under consideration, the taxpayers were paid a mobilization fees for and on account of mobilisation/ movement of rig from foreign soil/ country to the offshore site at Mumbai.

12.2.2.4 The taxpayer did not include the amount received as mobilization charges in the gross revenue for the purpose of computation under Section 44BB of the Act.

12.2.2.5 The AO included the amounts received for mobilization/ demobilization to the gross receipts to arrive at the 'profits and gains' for the purpose of computing ta under Section 44BB of the Act. The CIT(A) and the ITAT upheld the action of the AO.

12.2.3 Decision of Hon'ble High Court

The High Court also held that the mobilization charges reimbursed inter alia even for the services rendered outside India were taxable under Section 44BB of the Act. It also made an observation that taxability of such income is not governed by the charging provisions of Section 5 and 9 of the Act.

12.2.4 Decision of Hon'ble Supreme Court

12.2.4.1 The taxpayer filed further appeal before the Supreme Court in which following were the broad issues for consideration:

a. Whether mobilization fees is a reimbursement of expenditure actually incurred by the taxpayer?

b. Whether taxability of mobilization fees shall be examined only under Section 44BB of the Act or also under the provisions of Section 5 and 9 of the Act?

12.2.4.2 The Supreme Court decided both the issues in favour of the Department. It ruled that the mobilization fees was not a reimbursement of expense. The Supreme Court also held that amount received for mobilization of a rig was to be included to the gross revenue to arrive at the 'profits and gains' for the purpose of computing tax under Section 44BB of the Act.

12.2.4.3 Following are the **key takeaways of the ruling**:

a. The Supreme Court held that as per the agreement, the mobilization fees was payable for the mobilization of the drilling unit from the place of origin to the port of entry. A **fixed amount** of mobilization fees was payable under the contract as compensation. As the same is a fixed amount paid, which may be less or more than the expenses incurred, the same is not reimbursement of expenses.

b. The High Court in this case had held that the provisions of Sections 5 and 9 of the Act are not attracted in the instant case, as the taxability of mobilisation charges are government by Section 44BB of the Act. However, the Supreme Court held that the High Court, may not be entirely correct in law in excluding the provisions of Sections 5 and 9 of the Act in cases where the assessment is opted by the taxpayer under Section 44BB of the Act.

c. Section 44BB of the Act provides for special provision for computing profits and gains. However the Supreme Court observed that Sections 4,5 and 9 of the Act which deal with charging Section, total income and income of non-resident which arises or deems to arise in India cannot be sidetracked. These are the provisions which bring a particular income within the net of income-tax. Therefore, it is imperative that a particular income is covered by the provisions contained in Section 5 of the Act.

d. The Supreme Court observed that the Act follows a territorial system of taxation. As per this system only that income of a

non-resident is taxable in India which is attributable to operations within the Indian territory. Therefore, in the **first instance** it is to be seen whether a particular income arises or accrues or deems to arise or accrue within India. Accordingly, in case of a non-resident, the principles contained in Section 9 of if the Act have to be applied and only then it becomes an income-taxable in India as per Section 9 of the Act. The **question of computation of the said income would arise only after determining the taxable income in India as per the provisions of Section 9 of the Act.**

e. Section 44BB(2) of the Act makes certain receipts as 'deemed income' for the purposes of taxation in the said provision. Therefore, aid of this provision is to be necessarily taken to determine whether a particular amount will be 'income' within the meaning of Section 5 of the Act. Section 44BB(2) also acts as a guide to determine whether a particular income is attributed as income occurred in India.

f. From the bare reading of the Clauses of Section 44BB of the Act, the amount paid under the aforesaid contracts as mobilization fee on account of provision of services and facilities in connection with the extraction, etc. of mineral oil in India and against the supply of plant and machinery on hire used for such extraction, falls under Section 44BB(2)(a) of the Act.

g. Thus, the provisions of Section 44BB has to be read in conjunction with Sections 5 and 9 of the Act and Sections 5 and 9 of the Act cannot be read in isolation. The aforesaid amount paid to the taxpayers as mobilization fee is treated as profits and gains of business and therefore it would be 'income' as per Section 5 of the Act. This provision also treats this income as earned in India, fictionally, thereby satisfying the test of Section 9 of the Act as well.

h. When it is found that the amount paid or payable (whether in or out of India), or amount received or deemed to be received in India is covered by subSection (2) of Section 44BB of the Act, by fiction created under Section 44BB of the Act, it becomes 'income' under Sections 5 and 9 of the Act as well.

13. GENERAL NOTES ON TAX EVASION AND TAX AVOIDANCE BY MNCs

Aside from the broad issues in taxation of foreign companies including MNCs, especially taxing business profits through permanent establishments discussed above, it is important to understand that businesses of MNCs may be organized across different tax jurisdictions in a manner that exploits provisions of domestic laws to minimize taxation. Some of these methods are peculiar to scale of operations carried out by the multinational companies. The stage of operations in the host country and the rate of tax in the home and the host country also play a role in the tax planning of multinationals. Again some of the means may be outside the scope of an assessment as regular assessments start with the primary document i.e. a return of income. In such a case examining data from multiple sources such as Certificates u/s 197/ 195, Form 15 CA/CB, Data from Nonfiler monitoring system etc., also need to be examines to identify and determine actual tax liability of an MNC in India. While it is difficult to give a comprehensive list of devises resorted to by multinationals, some of the commonly adopted methods are discussed below:

13.1 Failure to File Return: Deliberate failure by non-residents to file tax return in the country in which they have taxable income is a manner in which assesses might attempt to avoid declaring taxable income. The aim is to

deter further investigation and assessment by deliberate omission to file the primary document i.e. a tax return. Such cases are often thrown up by system based on transactions captured in Form 15CA/ CB, Form 26AS etc., which should be examined to determine if an income has escaped assessment. Form 15CA/ CB cases specifically are periodically also selected by system for verification of transactions.

13.2 Failure to Report All Income Subject to Tax: Another practice in this category would be willful or negligent failure to report all items of international income which are subject to tax. The items more often omitted are receipts classified as reimbursement of receipts, sums being treated as nontaxable on account of argument that the same are neither royalty nor FTS etc.

13.3 Fictitious Deductions: In some circumstances fictitious business expenses may be claimed as deductions particularly if the purported recipient of the expense payment is outside the taxing jurisdiction and is therefore not subject to scrutiny by tax authorities of that jurisdiction. For example, if the tax payer purchases goods outside the taxing jurisdiction, false invoices may be prepared to show a purchase price greater than that actually paid by the tax payer. In many cases, commissions, royalties, technical service fees and similar expenses will be paid by a resident of the taxing jurisdiction to a related non-resident and claimed as deduction, even though the related non-resident has done nothing to earn such fees.

13.4 Suppression of Business Income: Taxes on business income are frequently reduced by omitting to keep accurate books and records within the taxing jurisdiction. Generally, a second set of books of accounts, which is accurate is maintained outside that taxing jurisdiction, but those records are normally beyond the reach of the authority of that jurisdiction. In respect of incomes to which the rule of territoriality often applies, some of the devices most frequently employed to shift profits properly allocable to the source country, include:

a. The establishment of artificial transfer prices for imports and exports;

b. The improper allocation of profits and losses; and

c. Licensing agreements under which the user of technology is obliged to purchase imported inputs, equipment and spareparts.

It may also be advantageous purely for tax purposes for a company of a particular country to conduct operations with partners in another country to create a relay in the form of a company established in a third country where taxes are low.

13.5 Credit for Fictitious Tax: A tax payer residing in one country and receiving international income from another country may seek to reduce tax in the first country, which allows a foreign tax credit as a method of reducing double taxation, by claiming fictitious or excessive credits for taxes allegedly paid to the other country.

13.6 Improper Characterization of Income or Expense Items: Tax is also reduced by improperly characterizing an income or expense item in order to make use of an exemption or a reduced rate of tax.

13.7 Inconsistent Characterizations: A tax payer may characterize a particular transaction in one way in country A, and in a contrary way in country B, in order to obtain tax benefits in each country. For example, advances by a parent in country A to a subsidiary in country B may be treated as equity in country A in order to avoid the necessity for reporting interest income to country A, but as debt in country B in order to avoid a capital stock taxes in country B. Payments made by a subsidiary in country A to its parent in country B may be treated as

the purchase price of goods in country A, but as royalties or dividends in the country B.

13.8 Use of Related Tax haven Entities to Reduce Taxes: Associate enterprises incorporated in tax havens are also used by multinationals for their tax planning. The following situations are worth considering:

a. A commonly used method is to transfer incomeproducing assets at an artificially low cost from the taxing jurisdiction to a controlled entity in a foreign taxhaven country where the potential income from the assets will be subject to tax at a lower rate, or escape tax entirely. These assets may be stocks, securities, rental properties and intangibles such as licensed patents, trade marks and copy rights which will generate continuing passive investments income, or property or any kind which will be resold by the tax haven entity to an unrelated third party at a gain.

b. Nominal transfer of incomeproducing functions to a tax haven entity that may be only a shell corporation that is incapable of performing the services unless it uses personnel and/ or property of the controlling entity.

c. Payment of deductible expenses to a taxhaven entity.

d. Payment of deductible expenses which benefit a tax haven entity.

CHAPTER

2

Information Technology Industry

1. INTRODUCTION

1.1 With the dawn of the new millennium, the age of information revolution has truly begun, and it has helped various other service sectors to reach billions of people, like no other. India is the world's largest sourcing destination for the information technology ('IT') industry, accounting for approximately 67 *Per cent* of the Rs. 826522 Crore market (USD 124–130 billion). This industry employs approximately a 10 million workforce. India's cost competitiveness in providing IT services, which is approximately three to four times cheaper than the US, continues to be the mainstay of its unique selling proposition ('USP') in the global sourcing market. However, India is also gaining prominence in terms of intellectual capital with several global IT firms setting up their innovation centres in India.

1.2 The ITBPM sector in India grew at a Compound Annual Growth rate ('CAGR') of 15 Per cent over 2010–15, which is three to four times higher than the global ITBPM spend and is estimated to expand at a CAGR of 9.5 Per cent to Rs. 2000250 crore (USD 300 billion) by 2020. India, the fourth largest base for new businesses in the world and home to over 3,100 tech startups, is set to increase its base to 11,500 tech startups by 2020, as per a report by Nasscom and Zinnov Management Consulting Pvt. Ltd.

1.3 India's internet economy is expected to touch INR 10 trillion (USD 151.6 billion) by 2018, accounting for 5 per cent of the country's gross domestic product (GDP), according to a report by the Boston Consulting Group (BCG) and Internet and Mobile Association of India (IAMAI). India's internet user base reached over 350 million by June 2015, the third largest in the world, while the number of social media users grew to 143 million by April 2015 and smart phones grew to 160 million.

1.4 Public cloud services revenue in India was expected to reach Rs. 5597.42 Crores(USD 838 million) in 2015, growing by 33 per cent year-on-year (yoy), as per a report by Gartner Inc. In yet another Gartner report, the public cloud

market alone in the country was estimated to treble to Rs. 1,26,91.05 Crores (USD 1.9 billion) by 2018. Increased penetration of internet (including in rural areas) and rapid emergence of e-Commerce are the main drivers for continued growth of data centre colocation and hosting market in India.

1.5 The Indian IT sector, with its unique mix of high quality manpower & low cost has emerged as the driving force of this sector on a global scale, with revenues in billions of dollars and an average growth rate of over 8%. Understanding the sector's significance, the legislature has provided various incentives in the form of various exemptions & deductions. However, when it comes to tax scrutiny, the IT industry remains one of the lesser understood sectors, in terms of its business activities and types of various modus operandi, used to avoid tax. This chapter proposes to address these issues and enumerate the techniques of investigation, to be deployed in scrutinizing the IT sector.

2. WORK PROFILE OF IT SECTOR

2.1 As per Nasscom[1] the IT industry is divided into the following business sectors:

a. IT services

b. Information Technology enabled Services

c. Software Products, Engineering Services and R&D

2.2 The activities performed in each of the above sectors is discussed below:

2.2.1 IT Services: Information Technology Services (IT Services) is the predominant sector and fastest growing segment of the Indian IT Industry. There are following six phases in every Software development life cycle model:

a. Requirement Gathering and Analysis: Business requirements are gathered from the customers, which are then analyzed for their validity and the possibility of incorporating the requirements in the system to be developed is studied. A Requirement Specification document is created which serves the purpose of guideline for the next phase of the model.

b. Design: In this phase the system and software design are prepared from the requirement specifications which were studied in the first phase. System Design helps in specifying hardware and system requirements and also helps in defining overall system architecture. The system design specifications serve as input for the next phase of the model.

c. Implementation/ Coding: On receiving system design documents, the work is divided in modules/ units and actual coding is started. This is the longest phase of the software development life cycle.

d. Testing: After the code is developed it is tested against the requirements to make sure that the product is actually serving the needs identified and gathered during the requirements phase. During this phase all types of functional testing like unit testing, integration testing, system testing, acceptance testing is done as well as nonfunctional testing are also done.

e. Deployment: After successful testing the product is delivered/ deployed to the customer for their use. As soon as the product is given to the customers they first do the beta testing. If any changes are required or if there are any bugs, then they will report it to the engineering team. Once the requisite changes are made or the bugs are fixed then the final deployment will happen.

f. Maintenance: Once the customers start using the developed system then the actual problems emerge and need to be solved from time to time.

[1]http://meity.gov.in/content/performancecontributiontowardsexportsititesindustry

In the export segment, the requirement stage and design stage predominantly happen overseas while coding & testing happens in India.

2.2.2 ITeS: Information Technology enabled Services are basically support services or ancillary services provided to the business groups. Although, ITeS encompasses a plethora of support services, major support services are discussed below:

Description	Activities Performed
Medical transcription	Since maintenance of a secretarial setup by a medical practitioner is an expensive one in a developed country and also bothersome, reputed doctors have a partner in India who does necessary secretarial services. The foreign doctor transmits his requirement by voicemail to his service provider in India which would be transcribed and attended to and the necessary output will be transmitted back to the doctor, for which certain service charges are charged. Medical transcriptionists take dictated medical records and produce an accurate hard copy for the medical practitioner. The skills needed are thorough knowledge of the medical terminology, computer skills and accurate listening, spelling and typing skills. These charges are much less than what would have been otherwise in their own country.
Insurance support services	Overseas Insurance companies scan their customer insurance forms and transmit to their Indian Service providers, who in turn, will capture the data from such scanned forms and update the database of the insurance companies. Further, the Indian Service Providers also assist in insurance claim processing also.
Payroll maintenance	Indian service providers provide payroll support services such as payroll maintenance, payroll processing etc for their overseas customers
Call Centres or contact service Centres	The Indian Call Centres act as the first stage of trouble shooting for the customers of their overseas clients. The minor problems are resolved by these call Centres whereas major problems are escalated to the relevant technical units.
Knowledge Process Outsourcing (KPOs)	These are high end ITeS wherein significant knowledge creation happens. For instance, underinvestment research services, the Indian tax payer will access various global databases and with the help of various mathematical models, will give the following inputs to their overseas clients 1. Which stock to invest/ divest 2. how much to invest/ divest 3. when to invest/ divest These inputs are time sensitive and are applicable to various stocks in multiple global markets. Thus, such services are knowledge intensive and high valueadded services.

2.2.3 Software Products & Engineering Services and R & D: This segment includes companies which develop software as a marketable product and sells it in the market. An example can be M/s. Quick Heal Technologies Limited which has developed QUICKHEAL as an antivirus system and FINNACLE which is a core banking software product developed by Infosys Limited, which are available as an off the shelf products for the users. The difference between the IT service provider & Software products developer, is that the IT service provider develops software for and on behalf of their clients whereas a Software product developer is the sole owner of the software he develops. Therefore, a software developer's income would consist of sale of software products or receipt of license fee/ royalty.

3. REVENUE MODELS

3.1 The Basic Existing Business Models of the IT Industry are as under:

a. ***Inventors*** create intangible goods or services. The main task is inventing (designing) the new service or product. This archetype is widespread in the software industry. Often, this task is expensive, especially when the inventor designs and programs software by leveraging developers on his or her own payroll. After the invention activities have ended, software companies use other archetypes for intangible products to make the software available to customers, such as the intellectual property (IP) distributor or lessor.

b. ***IP distributors*** sell their IP rights or another software vendor's usage rights to customers. Typical ways to distribute IP in the software industry are original equipment manufacturer (OEM) agreements for software components and distribution rights for redistributables. Redistributables are often bundled with development tools and integrated and shipped with a software product.

c. ***IP lessors*** provide intangible goods "for rent," such as when software companies provide software usage rights to customers.

However, most software companies have a hybrid business model because they're acting both as an inventor and IP distributor or IP lessor as under:

a. Inventor + IP Distributor

b. Inventor + IP Lessor

c. Pure IP Distributor (Purchase and resale of software)

d. Software Maintenance, Support and Consulting services

e. Software enabled services

3.2 Emerging Models

In addition to this classification of business models, software companies can differentiate their business models by offering *software as a product* (SaaP), *software as a service* (SaaS), or a combination of both.

a. SaaP means that the company delivers a copy of the software to the customer, who gets usage rights but not ownership. SaaP represents a hybrid business model. The customer carries the cost for the usage rights, support, maintenance and operations. Software as a product (SaaP) focuses on creation, providing usage rights and maintenance and support services

b. SaaS means the software vendor does not deliver the software, but the customer gets both access to the software and usage rights. The software vendor carries the cost of software support, maintenance, and operation. Software as a service adds operations of the software by lending hardware usage and additional services.

3.3 The other new business models in the industry are:

3.3.1 Financial Lessor: Software Company lends customers money to pay software license fees, e.g. SAP.

3.3.2 Additional IP Lessor: Crosslicensing agreement between two software companies to use each other's IP, agreement with hardware supplier to use embedded software.

3.3.3 IP Broker: Large software vendors have marketplaces that their partners use to advertise their solutions. Examples include SAP's EcoHub and Microsoft's Solution Finder.

3.4 Artificial Intelligence

3.4.1 Today, AI is heavily used for automation across several industries. Robots are already taking over jobs that do not require human intelligence. Many manufacturers are using robots to replace tasks such as welding, mining activities, movement of parts within a factory that were previously carried out by humans. The financial industry is seeing a heavy surge in the use of AI and machine learning for investment advisory.

3.4.2 Another domain which is seeing heavy use of AI is healthcare. AI is helping physicians to decide on the best treatment and predict future complications that a patient may encounter. Tasks such as differentiating a cancerous cell from a noncancerous cell can be easily achieved through AIbased tools. Thus, A.I. tools replace manpower resources and may ultimately result in reduction of workforce. The treatment of A.I. tools whether capital or revenue has to be examined on a factual basis.

3.5 Cloud Computing

3.5.1 Cloud computing is a method for delivering information technology (IT) services in which resources are retrieved from the Internet through webbased tools and applications, as opposed to a direct connection to a server. Rather than keeping files on a proprietary hard drive or local storage device, cloudbased storage makes it possible to save them to a remote database. As long as an electronic device has access to the web, it has access to the data and the software programs to run it.

3.5.2 The information being accessed is found in "the cloud" and does not require a user to be in a specific place to gain access to it. This type of system allows employees to work remotely. Companies providing cloud services enable users to store files and applications on remote servers, and then access all the data via the internet.

3.5.3 Different Types of Cloud Computing

Cloud computing is not a single piece of technology, like a microchip or a cell phone. Rather, it's a system, primarily comprised of three services: infrastructure as a service (IaaS), software as a service (SaaS)+ and platform as a service (PaaS). SaaS is expected to experience the fastest growth, followed by IaaS.

a. **Software as a Service (SaaS):** SaaS involves the licensure of a software application to customers. Licenses are typically provided through a payasyougo model or ondemand. This rapidly growing market could provide an excellent investment opportunity, with a Goldman Sachs report projecting that by 2018, 59% of the total cloud workloads will be SaaS.

b. **Infrastructure as a Service (IaaS):** Infrastructure as a service involves a method for delivering everything from operating systems to servers and storage through IPbased connectivity as part of an ondemand service. Clients can avoid the need to purchase software or servers, and instead procure these resources in an outsourced, ondemand service.

c. **Platform as a Service (PaaS):** Of the three layers of cloudbased computing, PaaS is considered the most complex. PaaS shares some similarities with SaaS, the primary difference being that instead of delivering software online, it is actually a platform for creating software that is delivered via the internet. A report by Forrester indicates that PaaS solutions are expected to generate Rs.2,93,942 Crores (USD 44 billion) in revenues by the year 2020.

3.5.4 Cloud computing has created a new borderless business environment in which taxing authorities are doing their best to keep up with changes in technology. The global fluidity of cloud results in tax compliance risks in terms of evaluating the location of the cloud business and its customers and assessing intragroup cloud transactions in accordance with the arm's length principle. However it also provides opportunities for multinational groups providing cloud services, either internally or externally, to consider a tax efficient structure/ strategy for the provision of such services.

3.5.5 Under the Income-tax Act, 1961 (ITAct), the definition of royalty covers both consideration paid for the right to use certain IP rights (such as copyrights, patents, secret formulae, etc.) and the right to use scientific equipment. A similar definition appears in several tax treaties signed by India. Upon a cursory analysis of the definition of 'royalty', it emerges that the same would cover within its ambit a majority of the cloud computing models. For example, if the customer is entitled to exercise sufficient dominion/ control over the cloud server or any part of its features, it may be treated as the use of scientific equipment and the payment to the thirdparty service provider would be treated as royalty income. A similar conclusion would follow if the cloud service envisages a transfer of the right to use certain intellectual property rights such as the copyrights in a certain software stored on the server of the thirdparty service provider which may be utilised by the client.

3.6 Gaming Industry

3.6.1 The size of the mobile and online games industry in India is Rs. 9001,200 crore and it is growing at 60–70 per cent. Online games are conducted through certified and tested software and all transactions take place through banking channels. The salient features of this industry are as under:

a. The gaming applications are normally hosted on a thirdparty server like Amazon Web Service located outside India.

b. The gaming applications are available to customers for download on free of cost basis on the Google Play Store and the Apple App Store. It can be downloaded by customers/ players located both in India and outside India from the Google Play Store/ Apple App Store.

c. T&Cs of Apple and Google, located outside India, is accepted for them to provide the platform for listing the gaming application, and to enable/ facilitate transactions in relation to the gaming application.

d. On the initial download of the game, a player is given a certain amount of virtual chips free of cost. If a player wishes to increase the stakes and play the game at a higher level, he is required to purchase virtual chips via the Google Play Store/ Apple App Store as the case may be, on payment of amount based on the quantity of virtual chips purchased.

e. Once the virtual chips have been sold to an end player, it can only be used by such player to play that specific game. The virtual chips cannot be redeemed against cash. The gains on winning are in the form of additional virtual chips to a player which can only be Utilised by such player to play the game further.

f. The players can pay for the virtual chips using Apple iOS and Google Android currency inapp payment option when playing the game through the respective platforms. Google/ Apple collect the money paid for purchase of Virtual Chips/ ingame currency by the customer through their portals. In this regard, an invoice is issued by Google/ Apple to the end customer indicating the item purchased and the price for the same.

g. A portion of the amount collected for every transaction of sale of virtual chips, is retained by Google/ Apple, towards the activities provided by Google/ Apple. The net amount after adjustments relating to their share of the revenue is remitted to game developers. In this regard, Google and Apple provide a periodical report of the amount collected by the end customers towards the purchase of virtual chips/ ingame currency, amount retained by them for the services provided and the net amount remitted.

h. To earn such revenue, the gaming companies incur expenditure both in local currency and foreign currency. For payments made to local vendors, appropriate tax is required to be deducted. Further, payments made to foreign digital marketing vendors are subject to equalization levy. Any other foreign vendor payment is subject to appropriate withholding tax.

i. Upon sale of virtual currency, the revenue is required to be recognised immediately as the services have been rendered although the player has an option to consume the virtual currency immediately upon purchase. Virtual currency once sold cannot be redeemed/ bought back i.e. players don't have option to redeem virtual currency.

3.6.2 A few foreign digital marketing vendors do not agree to equalisation levy deduction as they are unable to take credit of same in their respective home currency. In such cases, the amount is grossed up and remitted. The equalisation levy which is shown as an additional cost is to be disallowed.

3.6.3 Similarly, for technical expertise, many foreign vendors are engaged. Such vendors do not agree to withholding tax. In such cases, the amounts are grossed up and treated as additional cost. This is to be examined.

4. PROVISIONS IN THE ACT AND CIRCULARS IN RELATION TO IT INDUSTRY

The provisions of Sec 10 A and Sec 10AA of the IT Act, 1961 deal with deduction/ exemption in respect of profits and gains derived by an undertaking from the export of computer software and the newly established undertaking in Free Trade Zone/ units in Special Economic Zone. Further, the Board has issued various guidelines in the form of Circulars/ Notifications/ Instructions etc. regarding the eligibility and computation of the tax exemptions claimed by the IT industry in these Sections. A gist of these provisions and the important guidelines is presented in AnnexureA to this chapter.

5. CONTENTIOUS ISSUES RELATED TO ASSESSMENT OF SOFTWARE COMPANIES

5.1 Software Expenses Claimed as Revenue Expenses: The software purchases are in the nature of capital expenditures. The assessee is liable to treat this as a capital expenditure and claim depreciation at the rate of 60%. Instead, the assessees claim the same as revenue expenditure stating that it only bought the 'right to use' and did not purchase the software itself. If that were be the argument of the assessees, then it would amount to a royalty payment under the definition of royalty u/s 9(1)(vi) of the Income-tax Act. As per the same logic assessee is eligible for deduction at the rate of 25% only as applicable for intangible assets like knowhow, patents, copyrights etc.

5.2 Brand Building Expenses: The assesses, especially those having overseas business, incur considerable amount on "brand building"

activities which benefit them over a period and are not purely revenue in nature. Such expenses need to be claimed 1/ 5th every year and should not be debited to the profit and loss account, in one go.

5.3 Commission Paid to Non-residents: The assessees regularly pay commission to various non-residents for business purposes. Any commission paid to any foreign entity is for the purpose of obtaining services or increasing its revenue in India. The said commission payment attracts TDS u/s 195 of the Income-tax Act read with Section 5 and 9 of the Income-tax Act. However, often the assessees do not make any TDS on commission paid to non-resident commission recipients. Many a times the genuinity of such payments may be suspect. The judgment of the Hon'ble High Court of Karnataka in the case of M/s. Samsung Electronics Company Ltd. and others and has held that assesses are liable to make TDS on all such payments.

5.4 Communication Expenses Incurred in Relation to the Delivery of Software Outside India: The software companies spend considerable amounts towards communication expenses for delivery of software outside India for the STPI units and SEZ units. As per the provisions of Sec. 10A, this amount is to be reduced from the export turnover computed for the year. The assesses many a time do not reduce these expenses from the export turnover. This is required to be examined with relation to the evidences on record.

5.5 Expenses Incurred in Foreign Currency in Providing Technical Services Outside India: The assessees incur substantial amount of foreign expenditure outside India from the 10A units. These are in the nature of overseas salary, travelling expenses, overseas boarding expenses and similar expenses. The assessees categorize the same as related to development of software. It is seen that these expenses are in the nature of salaries to employees stationed abroad. A good part of this amount is also in the nature of per diem allowances, travel and living allowances and similar expenditure incurred in relation to providing technical services though the assessee is not in the business of providing technical services. The assessees claim these as expenses related to the business of providing software development services only. They claim that no such amount can be treated as expenditure related to providing technical services and no amount should be reduced from the export turnover, which is at divergence with the provisions of the Act. This issue should be scrutinised critically while examining such claim.

5.6 Interest Income Not Derived from the Eligible Business (Say on Group Leave Encashment Scheme Deposit with LIC) Not Allowed as Deduction u/s. 10A/ 10AA: There is a trend to claim deduction u/s 10A/10AA in respect of interest earned out of schemes like Group Leave Encashment with organisations like LIC as a part of revenue derived out of the activity of software development and export, which is blatantly wrong. In this context the decision of the Hon'ble Supreme Court in the case of *Pandian Chemicals Ltd* (262 ITR 278) as well as in the case of *Indian Leather Corporation Ltd.* (227 ITR 552) may be referred.

5.7 Revenues from Deputation/ Deployment of Technical Manpower Abroad

5.7.1 Deputation of Technical Manpower (DTM) or manpower contract receipt is one of the major components of revenue receipts of Information Technology (IT) companies based in India. These are receipts on account of deputing software engineers to work in companies based out of US or Europe on a shortterm basis. In short, it is a kind of labour arbitrage. Typically, an IT professional is sent on shorter assignments of 3 to 6 months to work under the control and

supervision of personnel at companies abroad. The offshore entity pays, say, US $ 6,000 per month to the Indian company for each of the software professional deputed. The Indian company pays a regular salary, say, Rs. 50,000 per month and also pays a per diem allowance to the software professional for all the days he spends abroad at the premises of the client abroad. Considering per day allowance of $ 100 given abroad and the Indian salary paid in Rupees, the software professional is paid a total remuneration of approximately US $ 4,000 equivalent. The balance amount is the profit earned by the Indian company for sending its employee professional abroad. This profit could vary based on the skill sets required, duration of DTM contract and a host of other demandsupply parameters. This bifurcation is required to be examined based on analysis of the facts of the case with specific reference to the terms of contract regarding management, control and supervision of the deputed employees. It is also to be examined whether the claim for exemption u/s 10A/10AA is made on such receipts and whether they fulfil the requisite conditions.

5.7.2 The proportion of DTM receipts to the overall revenue receipts of IT companies was estimated to be as high as 80% about a decade back. This proportion is reported to have steadily declined to roughly about 40% of the total revenue receipts of IT companies based out of India. Quantification of proportion of DTM contracts to total revenues is rather difficult considering the confidentiality required to be maintained by IT Companies to face intense competition in the company. The key features of such manpower contracts are:

a. The services rendered by the employeeprofessional of the Indian company at locations abroad are not under the control and supervision of the Indian company.

b. The proprietary rights over the output of employeeprofessional as well as all control, supervision and responsibilityliability is only with the company abroad.

c. The liability of the Indian company is restricted to providing the qualified persons onsite.

d. Such contracts are more of skillset oriented rather than projectbased.

5.7.3 There were two limbs of now phased out deduction u/s 80HHE as under:

a. Export out of India of computer software or its transmission from India to a place outside India by any means

b. Providing technical services outside India in connection with the development or production of computer software.

The first limb refers to development of any computer software offshore i.e., in India, where as the second limb refers to the activities in the nature of DTM contracts. It should also be borne in mind that, as discussed even in the Software Development Life Cycle (SDLC), development of computer software in India would also involve a small portion of onsite activity abroad at client's premises during the course of acquiring domain knowledge/ designing software as well as during the course of real time testing of software developed in India. The same practice has been very clearly defined by the CBDT's Instruction No 694 as below:

> *"Similarly, for the purpose of Sec. 10A or 10B, as long as a unit in the SPZ/EOU/STP itself produces computer programmes and exports them, it* ***should not matter whether the programme is actually written within the premises of the unit****.*
>
> *It is, accordingly, clarified that, where a unit in the EPZ/ EOU/ STP develops software surplace, that is, at the client's*

site abroad, such unit should not be denied the tax holiday under sec. 10A or 10B on the ground that it was prepared on site, as long as the ***software is a product of the unit*** *i.e.,* ***it is produced by the unit."***

5.7.4 Therefore, the crucial question here is whether the software was a product of the unit or not. It is to be appreciated that, the deductions given in Chapter VIA from 80HHC to 80HHF were **specific to the foreign exchange earnings** of the Indian companies. They do not have other limiting factors like the location of enterprise required to be within a STP, EOU, SEZ and the like. The deductions under these provisions were given as long as foreign exchange was earned and brought back to India from these activities of export of goods and services. But, deductions under Sections 10A, 10B and 10AA are **site specific deductions**. These deductions are given to specific eligible units which function within the custom bounded locations in STP, EOU and SEZ as applicable. The exports made out of these eligible units within STP, EOU, SEZ were only eligible for deduction u/s. 10A, 10B or 10AA. To this extent Sections 10A & 10AA are site specific.

5.7.5 The provision of Section 10A of the Act categorically stipulates as under:

"subject to the provisions of this Section, a deduction of such profits and gains as are derived by an ***undertaking from the export of articles or things or computer software*** *for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, shall be allowed from the total income of the assessee"*

From the above, it is seen that export of computer software is an eligible activity as long as it is conducted from a STP, EOU or SEZ. The definition of computer software is the same as the definition in sec. 80HHE as below:

Computer software means:

(i) Any computer programme recorded on any disc, tape, perforated media or other information storage device; or

(ii) Any customized electronic data or any product or service of similar nature as may be notified by the Board.

[which is transmitted or ***exported from India to a place outside India*** *by any means]*

As per notification No. 11521 dated 26092000 certain ***Information Technology enabled products or services*** were specified as under:

"In exercise of the powers conferred by Clause (b) of item (i) of Explanation 2 of Section 10A, Clause (b) of item (i) of Explanation 2 of Section 10B and Clause (b) of Explanation to Section 80HHE of the Incometax Act, 1961 (43 of 1961), the Central Board of Direct Taxes hereby specifies the following ***Information Technology enabled products or services****, as the case may be, for the purpose of said Clauses, namely:*

(i) Backoffice operations, (ii) Call centres, (iii) Content Development or Animation, (iv) Data Processing, (v) Engineering and Design, (vi) Geographic Information System Services, (vii) Human Resource Services, (viii) Insurance Claim Processing, (ix) Legal Databases, (x) Medical Transcription, (xi) Payroll, (xii) Remote Maintenance, (xiii) Revenue accounting, (xiv) Support Centres; and (xv) Website Services

Thus it can be seen that providing technical manpower services abroad in connection with the development of computer software is not included as eligible for deduction u/s. 10A of the Income-tax Act. The wordings in Sec. 10AA are similar to that of Section 10A.

5.7.6 An activity on which the software company based out of a STP or SEZ **has no control or supervision** cannot be said as an activity conducted from the said STP or SEZ. The mere presence of the corporate/Unit office inside a STP or SEZ premises **will not qualify the DTM contract** activity to be classified as conducted out of STP or SEZ. For a pure and simple DTM service activity, **one may be located anywhere**, as the space requirement for running an agency is rather limited. However, DTM services **cannot be equated to software development** or maintenance services. It is thus clear from the above analysis that the law makers specifically kept DTM services outside the purview of sec. 10A/ 10AA, which has been reiterated in the Circular No. 1/ 2013, dated 1712013.

5.7.7 Further, it is to be noted that one of the key conditions given out in the latest Circular is that–to claim the profits earned from the deployment of technical manpower abroad at the client's place–**the SOWs should have been made between the foreign clients and the individual unit claiming tax exemption.** The relevant extract is reproduced below:

> *"… The matter has been examined. Explanation 3 to Sections 10A and 10B and Explanation 2 to Section I0AA clearly declare that profits and gains derived from "services for development of software" outside India would also be deemed as profits derived from export. It is therefore clarified that profits earned as a result of deployment of Technical Manpower at the client's place abroad* ***specifically for software development work pursuant to a contract between the client and the eligible unit*** *should not be denied benefits under Sections 10A, 10AA and 10B provided such deputation of manpower is for the development of such software and all the prescribed conditions are fulfilled…."*

The said Circular has clearly laid out that the contract for software development should be between–the foreign client and the specific undertaking. **It is reiterated that such tax exemptions are not company specific–but unitspecific.** The profits of the DTM business do not have anything whatsoever to do with the profits of the undertaking. The profits of the DTM are also not software services within the definition of 'computer software'. The Circular is lucid and unambiguous on this point**.** This being the case, neither the assessee not the assessing officer is at liberty to interpret in any other way. **The conditions as laid out by the Circular have to be complied in letter and spirit to be eligible for the tax exemption claims.**

5.8 Onsite Revenue

5.8.1 The companies engaged in IT industry also have substantial amount of contract receipts from their onsite contracts. As mentioned earlier the important condition to be kept into consideration is that exemptions u/s.10A & 10AA are sitespecific i.e. unitspecific. If the business is conducted out of any foreign country with no link whatsoever to India or to any Indian STP/ SEZ units, then the assessee will not come within the purview of the Sections. When a specific SOW is executed for deploying both onsite as well as offshore resources, the benefit of doubt is to be given to the assessee as regards the work being executed from the Indian STP/ SEZ unit. However, at least a small portion of the work should definitely be conducted on the Indian shore i.e., in offshore location at STP/ SEZ units. Only when some part of the work is

done in Indian offshore location, the assessee can claim to have any direct and intimate relation of the work executed with that of the STP/ SEZ units. Thus the basic and undeniable requirement would be that at least some portion of the software development work is done in the Indian STP/ SEZ units and the assessee should be in a position to substantiate the nexus with the Indian eligible undertakings**.** In a case where no part of the SOW is executed on the Indian shores, it would be very difficult for the revenue to concede that the software services so rendered is a product of the unit i.e., produced by the unit. By drawing reference from Sec.2(32) as well as Explanation2 to Sec. 80IA(3) of the IT Act, one can held that at least 20% of any software development work should be done in Indian STP/ SEZ units leaving the balance 80% to be done abroad on the foreign shores. This is a reasonable standard set. By this yardstick, at least 20% of the SOW execution should be done on Indian shores in STP/ SEZ units.

5.8.2 The other aspects that are required to be considered while examining the onsite revenue are as under:

a. It is often found that the onsite contracts are not the product of the undertakings and are not related to the activity of the eligible unit/ undertaking.

b. SOWs were not entered between the foreign client and the eligible unit as required but were concluded between the client and the assessee company. In many cases the SOWs were entered between the client and the foreign branch offices of the assessee. Further, in many of the cases the invoices are signed centrally and not processed at the STPI/ SEZ unit levels.

c. Nexus between the work done abroad and the eligible Indian unit is one of the key criteria as laid out in the Circular No.1/ 2013. This has to be established by the assessee with the documentary evidence.

d. The assessee should present a detailed summary of the works/ projects that have been executed from its various centres abroad and its link to the domestic units.

e. When it has been claimed that the foreign offices have been used in connection with executing some of the works of the domestic units, the precise projects that have been delivered from these foreign branch offices should be made. Without this, linking those projects executed from the foreign branches to the domestic STPI units is not possible.

f. When all work is contracted by the company as a whole as per MSAs and SOWs the question arises as to how individual STP of SEZ unit will be in a position to Recognise revenue as their own? It cannot be ruled out that the said revenue might have been generated in an STP which has completed its 10 year tax holiday.

g. The role of the foreign branch of assessee concern where software development activity is conducted is also to be examined in the context of Indian content in a software activity conducted onsite at client's premises. Only this will establish whether onsite activity belongs to one or the other STP of SEZ.

5.8.3 The inferences made from the Circular No.1/ 2013 on this matter are as under:

a. That the benefits u/s. 10A/ 10B/ 10AA can be availed of only by the units or undertakings. To this extent, the tax holiday is availed of only **by the units and not by the assessee** at large.

b. That the Circular issued is **only an extension** of the earlier Circular No. 694 dated 23111994 issued on the same subject.

c. That the assessee as well as undertaking must prove a **direct and intimate nexus** or connection of development of software

done abroad with that of the eligible units setup in India.

d. Such development of software should be pursuant to the **contract between the client and the eligible unit**.

e. There should be a **contract between the client and the eligible unit** for providing such deputation of manpower for the development of such software.

f. In cases where the unit does not have **control and supervision** over the activities of deputed manpower and cases where the deputation is **not for such software development** activities are not eligible for deduction u/s. 10A/ 10B/ 10AA of the Income-tax Act.

g. The SOWs can be expected to prevail over the MSAs provided they enumerate the specific scope and nature of the particular task or project that has to be rendered **by a particular unit**.

In view of the above those assessees are not eligible for the tax exemption claim on the full revenues from the onsite work who has no nexus or link to the activities carried out from the domestic taxexempt units.

6. 10AA RELATED ISSUES

6.1 Splitting Up of Business

Unlike manufacturing concerns, in service industry splittingup typically involves shifting of manpower from an existing unit to eligible unit. One possible method of identifying the diversion of existing manpower is seeking a list of all employees in the new eligible unit and ascertaining their years of service in the company.

6.1.1 In this connection CBDT Circular 14 of 2014 requires to be perused. It allows assessee to satisfy either of the two specified requirements for not rejecting 10AA on the issue of diversion of manpower.

6.1.2 Employee cost is nearly 60% to 70% of the total debits to P&L A/c. Inflated cost or nongenuine employees is a concern. In order to ascertain whether all employees are genuine or not, PAN or PF No can be insisted for the entire employee roll. In some cases, it is possible that excess salary may be claimed in respect of exemployees who have left the company.

6.1.3 Vide Finance Act, 2017 the character of 10AA tax holiday has undergone a paradigm change from being a deduction to exemption. The quantum of exemption to be allowed is restricted to the total income of the assessee. Also the exemption is to be allowed in the final step only after total income of the assessee is computed. The preamendment scenario (as interpreted by the courts) is that exemption is granted to undertakings and therefore required to be determined at undertaking level. This interpretation resulted in a double jeopardy where 10A profit is substantial while noneligible units reported huge losses, which were allowed to be carried forward. With the stated amendment the ghost of Yokogawa has been put to rest.

6.1.4 Claim of bad debts after expiry of tax holiday on revenues where exemption had been claimed in preceding AYs is one issue that has emerged.

6.2 Scientific Methodology for Apportionment of Overhead Costs

The issue of shoringup profits in eligible undertakings resulting in simultaneous drop in profits of non-eligible undertakings is a live issue. This can be done by shifting the costs of eligible undertakings to noneligible undertakings. This is usually difficult to detect. A subtler method is lopsided allotment of entitylevel expenditure

i.e. allotting minimum overheads including interest to eligible unit and overallotting overheads to noneligible units. The A.Os. adopt their own methodology to apportion the overheads, most common being turnover based apportionment. Employee count is another possible method. It is, however, suggested that a standard methodology needs to be adopted for scientifically apportioning the overheads.

6.3 Foreign Tax Credit Issues

Major issues in the field of foreign tax credit is covered in the assessee's favour by the decision of the Hon'ble High Court in the case of M/s. Wipro Ltd 382 ITR 179 (Karnataka) (2016). However, the Hon'ble SC vide 240 Taxmann 299 (SC) (2016) has admitted the SLP filed by the revenue. The issues involved are:

a. Credit for taxes paid by assessee on 10A/10AA units simply put this is a scheme where assessee pays tax abroad and collects refund in India. In the name of avoiding double taxation the assessee ends up with double nontaxation.

b. Section 90 allows for foreign tax credit with countries where India has a DTAA. Section 91 allows for foreign tax credit with countries where India did not enter into a DTAA. IndoUSA DTAA allows tax credit for Federal Income-tax and not for State Income-tax paid in USA. However, the assessees are claiming FTC on State Income-tax paid through Section 91.

c. In one case the assessee had reported turnover net of indirect tax receipts. However, it also debited the indirect taxes separately to P&L A/c.

6.4 Trade Mispricing

Trading mispricing is reported to be one of the most common form of the tax evasion as per Global Financial Integrity Index. Underinvoicing software exports to associates enterprises is addressed by the Transfer Pricing Wing. However, there are software exports to third parties which also have an element of underinvoicing. A tacit or covert arrangement for diverting a portion of the consideration to unknown or untraceable entities is a possibility. FT&TR reference may made in suitable cases to ascertain any diversion of software export proceeds. Since FT&TR reference cannot be resorted to in every case, it is instructive to do conduct a study of Gross Profit of the assessee across A.Ys. and look for anomalies. A drop in Gross Profit on expiry of tax holiday period is a pointer for further investigation. A comparison of gross profit visàvis industry peers may throw up red flags. Also, a case where huge external commercial borrowing or foreign equity is reported from relatively unknown entities might be a case of reintroduction of diverted consideration. Focussed enquiry on export underinvoicing may be conducted in such cases.

6.5 Closing Stock & Unbilled Revenue

It is common for trading and manufacturing entities to report "closing stock" to balance the purchases which were yet to yield sales during the F.Y. This is a natural corollary of matching principle. In service companies, spotting closing stock in P&L A/c is a rarity. However, an item called "unbilled revenue" appears quite often in the Balance Sheet. It signifies that certain revenues have been recognised in anticipation of the services already provided, however, for which bills could not be raised. In such scenarios the AO may verify whether the unbilled revenue appearing in Balance Sheet has been incorporated in the reported turnover as well. If neither closing stock nor unbilled revenue appears in the financials, then the assessee needs to be questioned on this issue. In a very rare case where the monthly, quarterly or annual billing cycle exactly ends of 31st March of a financial year, such an exception is a theoretical possibility.

6.6 Billing Related Issues

Mostly the AO do not go beyond the billing submitted by the assessee. Most common issues on billing are:

a. The basic question on the bases of billing.

b. Outright diversion of billing from noneligible unit to eligible unit.

c. Diversion of certain component of billing from noneligible unit to eligible unit.

d. Crosscompensating overbilling done by an eligible unit through underinvoicing the work done by a noneligible unit.

It needs to be understood that a mega project is sliced into smaller projects to be handled by teams spread across countries also. It may be instructive to conduct a study of all export invoicing made by the assessee and then compare the peremployee output of an eligible unit visàvis and noneligible unit.

6.7 TDS Related Issues

6.7.1 It is observed that most of the IT companies claim expenditure on payment towards Royalty on software or IPR license received from the companies abroad. In most of the cases the companies abroad would be a related company/ Associated Enterprise (AE) of the Indian entity and there may be every possibility for the payment without any services being received from the AE. In these cases regardless of verifying the nature of services rendered the applicability of TDS on the payment has to verified as the services are rendered in India and to that extent the income has accrued to the AE in India.

6.7.2 Similarly in the case of Fee for Technical Services and IntraGroup services like administrative support, management support and accounting support the veracity of the claim of the assessee has to be verified based on the technical qualification of the person engaged and also with the applicability of the provisions of TDS. Lump sum paid to employees deputed abroad for meeting personal cost would fall within the ambit of perquisite and would attract TDS when there is no element of reimbursement of actuals.

6.8 80JJAA

This Section allows deduction on employment of new employees for the companies engaged in manufacturing to the extent of 30% of additional cost incurred for such expenditure. However, with effect from 1.4.2017, the provision has been amended to grant the deduction in all companies regardless of nature of business where the emoluments of such employees is less than Rs. 25,000/ per month. It has come to light that certain Software Companies have been claiming this deduction in the pre amended provisions on the ground that they employ skilled manpower. The eligibility criteria have to be thoroughly scrutinised with reference to acquittance roll and terms of employment.

7. Certain *modus operandi* leading to reduction/ tax evasion which has been detected are listed as under:

a. Generation of revenue or sales is accounted more in the exempt unit in comparison to the nonexempt unit though the actuals are otherwise.

b. Sales done but not realised in time as stipulated by Act.

c. Unbilled revenue

d. Inappropriate allocation of expenses between 10A/ 10AA unit and non 10A/ 10AA unit so that to reduce the profit of noneligible unit to reduce the tax burden and increase exempt income.

e. After the tenure for claiming 10A/ 10AA is exploited by splitting of existing unit an allegedly new unit is created for availing

deduction particularly with the same set of plant and machinery and with work force.

f. Claiming 10A/ 10AA deduction but not actually in to software development and outsourcing it/ subcontracting the work.

g. Claiming deduction under Section 32AC for investment in plant or machinery in software development companies as if they were in to manufacturing.

h. Payment towards royalty for IPR/ technology/ FTS at a fixed rate or varying rate without any services received so as to reduce the taxable income.

i. Payment in the name of intragroup services so as to divert the taxable income towards expenditure without nay services received from group companies only with documentation/

j. Reimbursement for administrative or managerial services allegedly received.

k. Claiming low end ITeS but actually into high end services like KPO, claiming software development as Engineering Design.

l. Body shopping/ secondment of employees.

8. SUMMARY

The information technology Industry in India is comparatively new one and highly untapped as of now due to many factors combined like,

a. It involves the understanding of the technology used by the assessee,

b. Involves cross border or borderless transactions,

c. Lack of knowledge about the maintenance and retrieval of accounts information, etc.

d. No regulation or regulatory body is available

Further the industry is highly dynamic and changing on day to day basis though it involves multi crore business across the globe. Hence it is right time that the department has to take a closer look towards the unexplored market giant so that to detect the new modes of tax evasion both within and cross border and to tap the potential tax for the nation.

ANNEXURE–A

1. SEC 10 A OF THE I-T ACT, 1961

*"**[Special provision in respect of newly established undertakings in free trade zone, etc.***

10A. (1) *Subject to the provisions of this Section, a deduction of such profits and gains as are derived by an undertaking from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, shall be allowed from the total income of the assessee:*

10A(3) *This Section applies to the undertaking, if the sale proceeds of articles of things or computer software exported out of India are received in, or brought into, India by the assessee in convertible foreign exchange, within a period of six months from the end of the previous year or, within such further period as the competent authority would allow in this behalf…*

*[**10A(4)** For the purposes of 28 [Sub-sections (1) and (1A)], the profits derived from export of articles or things or computer software shall be the amount which bears to the profits of the business of the undertaking, the same proportion as the export turnover in respect of such articles or things or computer software bears to the total turnover of the business carried on by the undertaking.]…*

Explanation 2*. (i) Computer software means*

(a) Any computer programme recorded on any disc, tape, perforated media or any other information storage device; or

(b) Any customized electronic data or any product of service of similar nature, as may be notified by the Board, Which is transmitted or exported from India to any place outside India by any means.

S.10A/ [Explanation 3]: *For the removal of doubts, it is hereby declared that the profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.] (Inserted by the Finance Act, 2001, w.e.f. 1.4.2001.)*

2. SEC 10 AA OF THE I-T ACT, 1961

"[Special provision in respect of newly established undertakings in free trade zone

10AA. *(1) Subject to the provisions of this Section, in computing the total income of an assessee, being an entrepreneur as referred to in Clause (j) of Section 2[73] of the Special Economic Zones Act, 2005, from his Unit, who begins to manufacture or produce articles or things or provide any services during the previous year relevant to any assessment year commencing on or after the 1st day of [74][April, 2006, but before the first day of April, 2021, the following deduction shall be allowed]:*

(i) Hundred per cent of profits and gains derived from the export, of such articles or things or from services for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the Unit begins to manufacture or produce such articles or things or provide services, as the case may be, and fifty per cent of such profits and gains for further five assessment years and thereafter;

(i) For the next five consecutive assessment years, so much of the amount not exceeding fifty per cent of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Reinvestment Reserve Account") to be created and Utilised for the purposes of the business of the assessee in the manner laid down in subSection (2).

Explanation 2: *For the removal of doubts, it is hereby declared that the profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.]".*

3. RELEVANT CIRCULARS, INSTRUCTIONS ETC

From time to time the CBDT had issued various guidelines in the form of Circulars etc regarding the eligibility and computation of the tax exemptions claimed. Following are the important ones to be kept into consideration:

a. Circular No 694 (23/11/1994)

b. Notification No. 11521 (26/09/2000)

c. Circular No. 1/2013, dated 17/1/2013

d. Instruction No. 17/2013, dated 19/11/2013

3.1 Circular No 694 (23/11/1994)

"Similarly, for the purpose of Sec. 10A or 10B, as long as a unit in the SPZ/ EOU/ STP itself produces computer programmes and exports them, it should not matter whether the programme is actually written within the premises of the unit. It is, accordingly, clarified that, where a unit in the EPZ/ EOU/ STP develops software surplace, that is, at the client's site abroad, such unit should not be denied the tax holiday under sec. 10A or 10B on the ground that it was prepared on site, as long as the software is a product of the unit i.e., it is produced by the unit."

3.2 Notification No. 11521 (26/09/2000)

"In exercise of the powers conferred by Clause (b) of item (i) of Explanation 2 of Section 10A, Clause (b) of item (i) of Explanation 2 of Section 10B and Clause (b) of Explanation to Section 80HHE of the Incometax Act, 1961 (43 of 1961), the Central Board of Direct Taxes hereby specifies the following Information Technology enabled products or services, as the case may be, for the purpose of said Clauses, namely:

(i) *Back-office operations,*

(ii) *Call centres,*

(iii) Content Development or Animation,

(iv) Data Processing,

(v) Engineering and Design,

(vi) Geographic Information System Services,

(vii) Human Resource Services,

(viii) Insurance Claim Processing,

(ix) Legal Databases,

(x) Medical Transcription,

(xi) Payroll,

(xii) Remote Maintenance,

(xiii) Revenue accounting,

(xiv) Support Centres; and

(xv) Website Services

3.3 Circular No. 1/ 2013 (17/ 01/ 2013)

The Hon'ble Prime Minister had setup a committee to examine the issues of taxation with respect to software sector under the chairmanship of Shri. Rangachary, former chairman of CBDT. The said committee submitted reports and based on the same. The Circular No.1/2013 of the CBDT was the outcome of the reports.

The important parts of the abovementioned Instructions etc are as under:

i. (a) Whether on site development of Computer Software Qualifies as an export activity for tax benefits under Sections 10A, 10AA and 10B of the Income-tax Act, 1961; And

(b) Whether receipts from deputation of Technical Manpower foronsite Software development abroad at the Client's place are eligible for deduction under Sections 10A, 10AA and 10B.

a. CBDT had earlier issued a Circular (Circular No. 694, dated 23.11.1994) which provided that a unit should not be denied taxholiday under Section 10A or 10B on the ground that the computer software was prepared onsite as long as it was a product of the unit, i.e., it is produced by the Unit. However, certain doubts appear to have arisen following the insertion of Explanation 3 to Sections 10A and 10B (vide Finance Act, 2001) and Explanation 2 to Section 10AA (vide Special Economic Zones Act, 2005) providing that the profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India; and a clarification has been sought on the impact of the Explanation on the taxbenefits as compared to the situation that existed prior to the amendments. The matter has been examined. In view of the position of law as it stands now, it is clarified that the software developed abroad at a client's place would be eligible for benefits under the respective provisions, because these would amount to deemed export and tax benefits would not be denied merely on this ground. However, since the benefits under these provisions can be availed of only by the units or undertakings setup under specified schemes in India, it is necessary that there must exist a direct and intimate nexus or connection of development of software done abroad with the eligible units setup in India and such development of software should be pursuant to a contract between the client and the eligible unit. To this extent, Circular No. 694, dated 23.11.1994 stands further clarified.

b. It has also been brought to notice that it is a common practice in the software industry to depute Technical Manpower abroad (at the client's place) for software development activities (like upgradation, testing, maintenance, modification, trouble shooting etc.), which often require frequent interaction with the clients located outside India. Due to the peculiar nature of software development work, it has been suggested that such deputation of Technical Manpower abroad should not be considered detrimental to the benefits of the exemption under Sections 10A, 10AA

and 10B merely because such activities are rendered outside the eligible units/ undertakings. The matter has been examined. Explanation 3 to Sections 10A and 10B and Explanation 2 to Section I0AA clearly declare that profits and gains derived from services for development of software outside India would also be deemed as profits derived from export. It is therefore clarified that profits earned as a result of deployment of Technical Manpower at the client's place abroad specifically for software development work pursuant to a contract between the client and the eligible unit should not be denied benefits under Sections 10A, 10AA and 10B provided such deputation of manpower is for the development of such software and all the prescribed conditions are fulfilled. …

3.4 Instruction No. 17/2013 (19/11/2013)

(i) A clarificatory Circular No. 01/2013 dated 17/01/2013 (hereinafter referred to as 'Circular') was issued by CBDT to address various contentious issues leading to tax disputes in cases of entities engaged in export of computer software which are availing taxbenefits under Section 10A, 10AA and 10B of the Income-tax Act, 1961.

(ii) Instances have been reported where the Assessing Officers are not following the clarifications so issued and are taking a divergent view even in cases where the clarifications are directly applicable.

(iii) The undersigned is directed to convey that the field authorities are advised to follow the contents of circular in letter and spirit.

CHAPTER

3

e-Commerce

1. INTRODUCTION

1.1 Commerce means buying and selling of goods and services. When buying or selling of goods and/ or services is performed electronically, it is called electronic commerce, or in short e-Commerce. e-Commerce is defined by US Treasury in 'Selected Tax Policy Implications of Global Electronic Commerce' as 'the ability to perform transactions involving exchange of goods and services between two or more parties using electronic tools and techniques'.

1.2 The following activities can be, interalia, undertaken using electronic tools and techniques:

a. Sale of goods (retail and wholesale) & services

b. Trading in stock

c. Online exchange of information

d. Health care advice

e. Offshore banking

f. Software programs

g. Transmission of data including in audio, graphics & video mode

h. Online advertising

The Internet or the worldwide web with its related technology is the backbone of ebusiness and digitalisation. It has the potential of revolutionising international business. The term Internet refers to an international network of computer networks. It has the capacity of connecting millions of computers throughout the world and thereby exchange information amongst their users on real time basis.

1.3 Some illustrations of buying and selling of goods, provision of services and licensing in e-Commerce are given below:

1.3.1 Buying and Selling of Goods: The vendor/ owner of e-Commerce marketplace like Amazon.in advertises the products (goods) of its own or of sellers on its Website. Potential customers access the Website of the vendor/ e-Commerce marketplace through Internet. The potential customers place an order for the goods on the Internet. Goods are delivered either through a local carrier or dedicated logistics provider. Payment for the goods is made either

by cash on delivery/ debit card/ credit card/ payment sites like Paytm/ ewallet etc. at the time of delivery or through online payment system. Examples of online emarketplaces operating in India include Amazon, Flipkart, Snapdeal etc.

1.3.2 Services Professional services, Legal advice, Health care services, Information services and Technical services are some of the fast growing activities on the Internet. Subscribers can type queries that can be transmitted to specialists and get responses through Email. Services can be booked online for e.g. pest control services on www.urbanclap.com, household services like plumber, electrician though website www.housejoy.com. Payments for the services can be made by cash/ cheque/ credit card/ ewallets or through online payment system.

1.3.3 Licensing: Products under copyright like journals, books, music, designs, drawings and software are available in digitised form. These products are delivered electronically to licensee with limited rights of user (with restriction of not making copies and selling). License fees are paid by cheque/ debit card/ credit card/ ewallets or through online payment system. Examples include Amazon Prime Video, Netflix and Hotstar. Movies, music and TV shows can be watched online by subscribing to these sites.

1.4 India's *e*Tail: ('*e*Tail' means retail conducted via the internet) and Online Marketplace segment continues to grow at a doubledigit pace every year, taking a substantial share from physical retail stores bit by bit. Adoption of smartphones and increasing penetration of internet have continued to drive the growth of the *e*Tail and Online Marketplace. The marketplace model will require an Indian marketplace entity to be significantly capitalised and funded. When such funding is provided by a foreign company, it will be entitled to a return for providing funds to the Indian entity. The return will depend on the functions performed by the foreign company. Some of the new ways of doing business include:

1.4.1 Online Retailer Model, whereby online platforms sell goods or connect buyers and sellers in return for a transaction or placement fee or a commission. Examples, include Amazon, Flipkart, Snapdeal etc.

1.4.2 Social Media Model, whereby network owners rely on advertising revenues by delivering targeted marketing messages to consumers. Examples include Facebook, Linkedin etc.

1.4.3 Subscription Model, whereby platforms charge subscription fee for continued access to a digital service (e.g. music or videos). A new medium in personal entertainment that has emerged over the last few years is overthetop (OTT), a term used to describe delivery of entertainment (TV programmes, movies and music) via the internet, without consumers having to subscribe to a cable or satellite TV provider. It is important to evaluate whether the consideration paid by OTT Co. to obtain a license from foreign content providers is taxable in India as royalty. Furthermore, provision of royalty under the Act allows exclusion of any content from sale, exhibition or distribution of cinematograph film. OTT Co. receives a consideration from India Co., advertisers or subscribers. It needs to be evaluated whether this consideration from India Co., advertisers or subscribers qualifies as royalty (for copyright, process or equipment), considering the provisions of the Act and Indian tax treaties. Examples include Netflix, Amazon prime video etc.

1.4.4 Collaborative Platform Model, whereby digital platforms connect spare capacity and demand, use reputational currency mechanisms to underpin consumption, and enable individuals to share "access" to assets rather than own them outright. Platforms charge a fixed or variable fee on each transaction. Examples of businesses include Airbnb, Quiker.com etc.

2. WHAT IS e-COMMERCE?

2.1 Electronic Commerce, or e-Commerce, has been defined broadly by the OECD Working Party on Indicators for the Information Society as "the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or service do not have to be conducted online. An e-Commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations" (OECD, 2011).

2.1.1 e-Commerce can be used either to facilitate the ordering of goods or services that are then delivered through conventional channels (indirect or offline e-Commerce) or to order and deliver goods or services completely electronically (direct or online e-Commerce)...."

2.2 The BEPS Report on Action 1 (2015) lists some of the more prevalent forms, as under:

a. **Business-to-Business Models:** The vast majority of e-Commerce consists of transactions in which a business sells products or services to another business (socalled businesstobusiness, B2B). This can include online versions of traditional transactions in which a wholesaler purchases consignments of goods online, which it then sells to consumers from retail outlets. It can also include the provision of goods or services to support other businesses.

b. **Business-to-Consumer Models:** B2C models fall into several categories, including, for example, socalled "pureplay" online vendors with no physical stores or offline presence, "clickandmortar" businesses that supplemented existing consumerfacing business with online sales, and manufacturers that use online business to allow customers to order and customise directly.

c. **Consumer-to-Consumer Models:** Businesses involved in C2C e-Commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions.

2.3 Significance of User Data in Nexus and Value Creation: Users and customers become an important part of the value creation chain. The logical sequence to this inference is whether the value creation achieved in this manner should be brought to tax in the locations from where the user data is generated. Whether any profits attributable to the remote gathering of data by an enterprise should be taxable in the State from which the data is gathered? There are questions about whether data is being appropriately characterised and valued for tax purposes, as well. This issue assumes importance in the context of the use of Facebook data by UK firm Cambridge Analytica.

2.4 Cloud Computing Services: The popular term for the delivery of infrastructure, platform, or software to external customers via the internet. Potential characterizations include service, sale, lease, or license. A distinguishing feature of a sale, lease, or licensing transaction, as opposed to a services transaction, is that for transactions in the former categories, property or property rights are transferred from the taxpayer to its customer. In a pure services transaction, property is not transferred. Cloud creates the possibility for an organisation to conduct seamless business without any physical presence. Service offerings may be fragmented across multiple jurisdictions, which creates difficulty in ascertaining the sites of the transaction. This raises issues relating to residency, source and whether or not there is taxable presence in a particular country to grant

a taxing right. The taxability of cloud service providers would depend on characterization of the underlying transaction i.e. whether the income is 'royalty' or 'fees for technical services' or whether the service provider has a taxable presence in India. Service recipients need to consider the withholding tax implications. Tax alignment issues could emerge as intangibles and related business activities flow more readily through clouds. Foreign Co. needs to evaluate whether payment received from Indian Co. or its customers for sale of space on a server is taxable as software royalty, process royalty or equipment royalty. The company should be mindful that Indian Co. can create a PE for Foreign Co. in India, depending on the location of the server or website, the number of Foreign Co.'s employees visiting India, etc. Foreign Co.'s income will be taxable in India at the rate of 40%, if PE is triggered.

2.4.1 Service Models of Cloud Computing Include

a. **Software as a Service (SaaS):** This model allows the consumer to use provider's applications running on a cloud infrastructure. Applications can be accessed from various client devices through a thin client interface, such as webbased email.

b. **Platform as a Service (PaaS):** PaaS allows the consumer to deploy onto the cloud infrastructure, consumercreated or acquired applications created using programming languages and tools supported by the provider.

c. **Infrastructure as a Service (IaaS):** This model allows the consumer to obtain processing, storage, networks, and other fundamental computing resources and be able to deploy and run a range of software. PE exposure would be high in the case of the IaaS model, where services are provided through hardware or servers to customers in India.

d. **Private Cloud:** Operated solely for an organisation, a private cloud may be managed by the organisation or a third party and may exist on or off the premises.

e. **Public Cloud:** The infrastructure is made available to the general public or a large industry group and owned by an organisation selling cloud services.

f. **Hybrid Cloud:** This infrastructure combines two or more clouds (private, community, or public) that remain unique entities.

In all the three models—IaaS, SaaS and PaaS—the cloud service provider (Foreign Co.) is required to maintain and operate the server or infrastructure and charge fees for its maintenance. It needs to be evaluated whether these fees qualify as FTS under the Act and Indian tax treaties. If Foreign Co. transfers IP to Indian Co. to develop software, there is a need to analyse whether the amount payable by Indian Co. to Foreign Co. qualifies as royalty.

2.4.2 Selling of Server Space by Indian Co. on Behalf of Foreign Co: Whether Indian Co. will be entitled to compensation for marketing and sales support services provided by it to Foreign Co., depends on functional analysis. The Indian Co. may be remunerated on the costs incurred by it to provide such services in addition to an arm's length markup on these costs. Selling of server space by Foreign Co. to customers in India may create a PE exposure for it in India.

2.5 e-Commerce Marketplace: Sellers can list and sell their items in India e.g. amazon. in. It also provides logistics services (storage, packing and shipping) in relation to goods sold on marketplace on request basis. It has the right to use of all related intellectual property

including e-Commerce technologies and tools, brand names, URLs and IP addresses, domain name etc. Sellers use a web portal called Seller Central to create their account. They list their products for sale on the Marketplace, determine prices of products and create shipments to be sent to warehouse. The sellers name along with the product is listed on website for the customer to purchase. The emarketplace charges fees for listing and logistics services at an agreed rate. The fees depend on combinations of services and categories of products. The fees charged to sellers include 'easyship charges', and 'delivery service fee'. Emarketplace incurs sales promotion expenses to promote the marketplace.

3. ONLINE PAYMENT SYSTEM

3.1 Paying for online transactions require providing of a bank account or credit card information to a vendor. Online payment service providers provide a secure way to enable payments online without requiring the parties to the transactions to share financial information with each other. A payment service provider acts as an intermediary between online purchasers and sellers accepting payments from purchasers through a variety of payments methods including credit card payments or bank based payments like direct debit or real time bank transfers processing those payments and depositing the funds to sellers account.

3.2 Electronic payment systems offer advantages like (i) protection against fraud, (ii) faster delivery of payment, (iii) ability to transact in multiple currencies. In India, the online payment system comprises several types of Service Providers like: Rupay, CCAvenue, Citrus Pay, EBS, Paypaland PayUbiz and PayUMoney. CCAvenue supports almost every bank and payment option. Then there are mobile wallets including PayTM and Mobiwik. There are ewallets by Paypal, ITZ Card and Oxicash. Currently, Secure Sockets Layer (SSL) security, is used to protect credit card information transmitted over Internet. SSL protects credit card information from being stolen by anyone monitoring the Internet traffic.

4. INCOME-TAX ISSUES IN *e*-COMMERCE

4.1 From the point of view of taxation the transactions relating to e-Commerce can be divided into the following categories:

a. Transactions relating to sale of goods or rendering of services by a domestic enterprise to another domestic enterprise or to an individual resident in India.

b. Transactions in which goods are sold or services rendered by a domestic enterprise to an enterprise or an individual situated outside India.

c. Transactions in which goods are sold or services rendered by an enterprise or an individual resident in a foreign country to an Indian resident.

4.2 First type of transactions are not likely to cause any more problem to tax authorities than a similar transaction made in the conventional form. Both the parties are resident in India. Such transactions would result in profits that could be unearthed and taxed over the limitation period under the Act, just as in the conventional form.

4.3 Second type of transactions are also unlikely to pose any problem, so long as they are transactions relating to export of tangible goods. Such exports are subject to customs, RBI and other regulations. Money is required to be remitted under the RBI regulations at least for the time being. Further, various tax incentives provided under the Income-tax Act make tax evasion manoeuvres unattractive. However, transactions relating to online services may pose considerable difficulty if the Indian party takes the payment abroad and keeps it in a bank account in a taxfriendly jurisdiction. Under the

new Foreign Exchange Management Act offences relating to foreign exchange will be treated as civil offences. The various incentives provided under the Income-tax Act are being phased out. These factors may give rise to a tendency of not reporting profits from such transactions. Due to the anonymity over the Internet, it would be virtually impossible for tax authorities to trace such transactions. The source of profit in respect of the first two types of transactions lies in India. Such profits are taxable in India under the head 'profits and gains of business or profession'.

4.4 Taxation of the third type of transactions mentioned above, involves a number of legal problems. These legal positions also differ for tangible and intangible assets. Incidence of tax on income depends upon the residential status of the assessee. Total income of a resident includes all income from whatever source derived which

a. Is received or is deemed to be received in India in such years by or on behalf of such person; or

b. Accrues or arises or is deemed to accrue or arise to him in India during such years; or

c. Accrues or arises to him outside India during such year.

Total income of a non-resident includes the first two items above, but these persons are not taxed for the income that accrues or arises to them outside India. The position in most other countries is broadly similar.

4.5 So long as the **source** and **residence** occur in only one country, there would be no problem. It is frequently possible that a person may be found to be a resident in more than one country or that the same item of his income may be liable to be treated as accruing, arising or received in more than one country. This may result in the same item of income becoming liable to tax in more than one country in the hands of the same person. In such situations, the countries resolve the mechanism of taxing such transactions through double taxation avoidance agreement. To prevent this hardship of double taxation, Section 90 of Income-tax Act, 1961 has been enacted.

4.6 In most of the Double Taxation Avoidance Agreements (DTAA), two countries agree that income from various sources that are likely to be taxed in both the countries should be taxed only in one of the countries. Country of source normally taxes the dividend and interest i.e. return for financial investments and royalties and technical services fees i.e. return for technology transfers, irrespective of whether there is a permanent establishment of foreign enterprise in the country of source. However, for taxation of sales income (i.e. business income) in the country of source, it is essential that there be a permanent establishment of the foreign enterprise in the country of source.

4.7 Double Taxation Avoidance Agreements are based on the following principles with regard to residence and with regard to source

5. TAXATION BASED ON RESIDENCE

a. Country of residence is the place with which a taxpayer has the closest personal links;

b. Country of residence generally taxes its residents on their worldwide income.

TAXATION BASED ON SOURCE

a. Country of source is the country with which income has the closest economic connection

b. Country of source taxes income sourced in that country

c. Country of source normally taxes dividend, interest, royalty and fees for technical services

d. Country of source taxes business income only when there is a permanent

establishment (PE) of foreign enterprise in the country of source, to the extent such income is attributable to the permanent establishment.

Wherever a Double Taxation Avoidance Agreement has been entered into between the Central Government and the Government of any other country, then the provisions of DTAA prevail over the provisions of Income-tax Act.

5.1 The following areas of the Digital Economy are employed for reducing taxes in the market country:

5.1.1 Avoiding a Taxable Presence: A non-resident company may interact with customers in a country through a website or other digital means (e.g. application on a mobile device) without maintaining a physical presence. MNEs may artificially fragment their operations among multiple group entities to qualify for exceptions to PE.

5.1.2 Minimising Functions, Assets and Risks in Market Jurisdictions: MNEs may allocate functions for tax purposes in ways that may not correspond to actual business functions performed. In addition, assets, in particular intangibles, and risks related to activities carried out at local level may be allocated via contractual arrangements to other group members operating in low tax environment.

5.1.3 Maximising Deductions in Market Jurisdictions: MNEs may reduce taxable income by maximising use of deductions for payments made to other group companies in form of interest, royalties, service fees, etc.

6. GUIDING PRINCIPLES BY OECD FOR CHARACTERISATION OF INCOME

6.1 One of the basic principles of taxation is the Principle of neutrality. This principle postulates that economically similar incomes, should be taxed similarly. In other words, the same tax treatment should be meted out irrespective of whether a transaction is carried out through electronic medium or otherwise. US Department of Treasury and the Organisation of Economic Cooperation and Development (OECD) are two organisations who have engaged themselves in identifying the problems in the taxation out of e-Commerce, and attempting solution of these problems. Both US Department Treasury and Committee of Fiscal Affairs of OECD have affirmed that:

a. Principle of neutrality should be observed in the taxation of e-Commerce transactions also, and

b. Taxation principles that guide governments in relation to traditional commerce should also guide them in relation to e-Commerce.

6.2 But there may be difficulties to enforce the same rules in the taxation of e-Commerce transactions, as in the taxation of traditional commerce transactions. The approach of both US Treasury and OECD has beento adopt and adapt the existing principles to the e-Commerce situations, rather than to go in for entirely new measures.

6.3 Double taxation avoidance agreements normally refer to the concept of permanent establishment, which in theory is akin to the concept of business connection. The concept of permanent establishment is defined in all DTAA treaties. Because of its definition, it is a narrower concept than business connection. Business connection, for the purpose of Section 9, may be held to have been established through an agent. However, such an agent should be one, who is devoted exclusively to the foreign principal. In other words, the agent should be dependent agent. In such an event, the theory of territorial nexus would be deemed to have been satisfied through the agent.

7. IMPLICATION OF RECENT CHANGES

7.1 Significant Economic Presence (SEP): This concept is introduced in Incometax Act 1961 w.e.f. 1.4.2019 and will apply in relation to AY 2019–20 and subsequent years based on BEPS Action Plan. Introduction of SEP concept in domestic law would enable India to renegotiate its tax treaties and introduce this concept of taxability of business income in source country even when a PE or a fixed place of business is absent in presence of SEP. SEP is defined under Explanation 2A in Clause (i) of subSection (1)of Section 9. The proposal to create this new tax nexus is aimed at tackling the direct tax challenges posed by digital economy. How to attribute profits to an SEP would be a key question which requires to be answered.

7.2 Business Connection in Respect of Agent who Habitually Concludes Contract: Clause(a) of Explanation 2 has been substituted by Finance Act 2018 and provides that business connection would now also include business activity carried through a person who habitually plays the principal role leading to conclusion of contracts by the non-resident and the contracts are in the name of the non-resident; or for the transfer of the ownership of, or for granting of the right to use or for provision of services by that non-resident. This is in line with the expansion of the concept of PE under Multilateral Instrument (MLI) to prevent BEPS. Where profitsis attributed to such an intermediary, Article 9 of OECD MC would permit adjustments of profits of the Associated Enterprise under TP regulations in its country.

7.3 Ant-ifragmentation Rule (New Para 4.1 of Article 5 of OECD MC): The BEPS action plan has recognised this rule that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefits from the exceptions of Article 5(4) of OECD MC. However the activities if combined '*constitute complementary functions that are part of a cohesive business operation*'.

7.4 If an income arises from sale of a product, it is business income. When all rights in a property (risk and reward of ownership) are transferred, it would amount to a sale giving rise to business income. On the other hand, when only limited rights in a property are transferred, the transferor retaining substantial rights therein, the income therefrom would be:

a. Royalty in the case of intellectual properties, or

b. Lease rent in case of tangible properties.

Royalty is subjected to taxation on gross basis in the country of source, irrespective of whether there is a permanent establishment or not.

7.5 If the result of a transaction is the rendering of services, the income from such services should be characterised as:

a. Fees for technical services, or

b. Fees for professional services.

Fees for technical services are taxed on gross basis in the country of source without the existence of a permanent establishment. Fees for professional services are subjected to tax on net basis (after deducting all expenses) in the country of source only if there exists a fixed base, which is conceptually equivalent to permanent establishment.

7.6 The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation under current rules of payments made in the context of new business models, particularly in relation to cloud computing.

8. TAXATION OF TRANSACTIONS IN SOFTWARE

8.1 As per Explanation (b) below Section 80 HHE of IT Act, 'Computer software' means any computer program recorded on any disc, tape, perforated media or other information storage device and includes any such program that is transmitted from India to a place outside India by any means. Software is essentially a computer program. Computer programs are covered by the Copy Right Act 1957. Therefore, software would be covered within the term copy right as defined in Copy Right Act 1957.

8.2 The rights in software are a form of intellectual property. If the entire rights in the software are alienated, then it would amount to **sale** and the income therefrom would partake the characteristics of **business income.** If only a limited right in the software (like right to use) is transferred, then it would amount to **licencing** and the income therefrom would partake the characteristics of **royalty.**

8.3 Section 9 (1) (vi) of the Income-tax Act deems, interalia, the following types of **royalty** income to accrue or arise in India:

a. Income by way of Royalty payable by a person who is a resident, except where the Royalties payable in respect of **any right,** property or information **used** or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

b. Income by way of royalty payable by a person who is a non-resident, where the royalty is payable in respect of **any right,** property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

8.4 Definition of Royalty U/s 9(1)(i) was amended by Finance 2012 with retrospective effect from 01.04.1976. Explanation 4 was inserted to clarify that transfer of all or any rights in respect of any right, property or information includes transfer of all or any right for use or right to use a computer software (including granting of a license).

8.5 Both, the US treasury's approach and the OECD's approach to software transactions are based on the concept of copyright**.**

8.6 In the Indian context, the High Courts have had divergent views, drawing a distinction between payment for the use of a copyright and that for a copyrighted article. On the one hand, it has been held that "license is granted to make copy of the software (contained in shrinkwrapped/ offtheshelf software) and to store it in the hard disk and to take a copy and right to make a copy itself is a part of copyright." Accordingly, what is transferred is right to use the software (Karnataka HC in Samsung Electronics Company Ltd.). On the other hand, several Courts have held that no right is transferred in the case of sale of software [Delhi High Court in Ericsson].

9. PERMANENT ESTABLISHMENT

9.1 Under the DTAA treaties based on OECD's model tax convention, the profit of an enterprise of a contracting State shall be taxable only in that State unless the enterprise carries on the business in the other contracting State through a permanent establishment situated therein. The term permanent establishment is defined in each Double Taxation Avoidance Agreement (DTAA). For understanding the concept of permanent establishment, its definition contained in Article 5 of the DTAA between the United States of America and India can be taken as a model and analysed. The general criteria for determination of **permanent establishment** are as under:

a. Permanent Establishment is a **fixed place of business** through which business of an enterprise is wholly or partly carried on. **[Article 5(1)]**

b. Positive lists of **fixed places of business** *viz.* a place of management, a branch and an office etc. are given. **[Article 5(2)]**

9.2 Both these clauses require that there should be a geographical link between the enterprise situated abroad and the country in which business is done. Article 5(2**)** requires that if the business activities are part of a construction or installation project, then it should last more than the minimum prescribed period. Further, the activity of the permanent establishment must directly or indirectly lead to income. If the activities that are too distant from the earning of profits, then such activities could not be equated to carrying on of the business. That is why, negative lists i.e. examples of activities *viz.* use of facilities solely for the purpose of storage, display, delivery of goods that are of preparatory or auxiliary character are excluded from permanent establishment**. [Article 5(3)]**

9.3 In order to find out whether the activity would constitute a permanent establishment or not, the following questions should be answered:

a. Is the activity carried on as a part of the business or is merely preparatory or auxiliary to it?

b. Does the activity lead to income?

If the answers to the above two questions are 'yes', then there is a permanent establishment**.** If the answers to the above two questions are 'no', then there is no permanent establishment**.**

9.4 The existence of a dependent agent who acts on behalf of an enterprise and who has habitually exercised an authority to conclude contract in the name of an enterprise, constitute a permanent establishment. The main characteristic of a dependent agent is that he should have an authority to conclude contract on behalf of the principal. [Article 5(4)]

9.5 The independent agents like brokers, general commission agents who act as such in their ordinary course of business are not construed as permanent establishment. In such cases, the agent is an agent of other principals as well in his ordinary course of business. [Article 5(5)]

9.6 Companies controlling or controlled by other companies are not treated as permanent establishment for the only reason that the company controls or is controlled by another foreign company. [Article 5(6)]

10. PERMANENT ESTABLISHMENT IN e-COMMERCE

10.1 The network technology including the Internet enables persons to carry on various income earning activities at locations where they were never present. Therefore, the concept of physical location of residence (including permanent establishment) would appear to be meaningless in the context of **e-commerce**. The place of effective management could be different from the location of operation.

10.2 Internet has no physical presence or location. **Website** can be viewed and accessed from a computer anywhere from which information can be downloaded. Computer that stores information contained in the Website for access by users of the network, including the Internet is called **server.** Server also describes the software that makes the process of delivering information possible.

10.3.1 In this backdrop, the following questions are to be addressed:

a. Whether a **website** can constitute a permanent establishment?

b. Whether a **server** can constitute a permanent establishment**?**

10.3.2 Whether the Website Can Constitute a Permanent Establishment:

A Website is nothing but data and programs in digitised form, which is stored on the server of the Internet Service Provider. Hence, it is possible to argue that a Website is not a fixed place from which business is carried on. In order to constitute a permanent establishment, there has to be a fixed place from which the business is carried on. This presupposes a certain degree of permanence, but not necessarily a permanent place of business fixed to land, e.g. a floating oil rig in territorial waters may constitute a Permanent Establishment. Therefore, it is very difficult to hold that the existence of Website by itself would constitute a permanent establishment. Nonetheless, one can examine whether the website is being used as a 'virtual office' in order to transact purchases/ sales or to render services in a systematic and continuous manner. In such a case, it may constitute a P.E.

10.3.3 Whether Server can Constitute a Permanent Establishment: A server is a computer which hosts the Website. One of the basic criteria for the permanent establishment is the requirement of a fixed place of business in the country where the business is wholly or partly carried on. However, OECD position is that Servers may be PEs–if foreign enterprise owns, leases or has at its disposal servers or computer equipment at a fixed location, then such equipment may be PE under normal rules.

10.4.1 The concept of permanent establishment deals not only with fixed place of business but also with the place of actual carrying on of the business. Keeping in mind, provisions of Articles 5(2) and 5(3) of the DTAA, determination has to be made as to the nature of operation and the extent of operation carried out through the server in the country of source.

10.4.2 Nature of Operation: If the operations carried out by the server is merely for storage and display of information, then the server does not play any direct role in economic activity of the host state. Servers carrying on activities of preparatory or auxiliary nature can also not constitute a permanent establishment, in the light of Article 5(3) of the DTAA.

10.4.3 Extent of Operation: If the server has a direct role to play in the economic activity in the host State, then such server may constitute a permanent establishment. For example, if the server acts as warehouse for digitised goods like software books, music through which such digitised goods can be traded, then such a server can constitute a permanent establishment.

10.5 Another relevant question that arises is, whether a **smart server** is a dependent agent and hence a permanent establishment? A smart server can not only provide information but also process orders from the persons making hits on the Website. One view could be that such a smart server has the power to contract on behalf of the foreign enterprise and therefore is a dependent agent of the foreign enterprise. Hence a smart server can be held to be a permanent establishment within the meaning of Article 5(4) of the DTAA. A contrary view is also possible, because only a person and not a machine could be a dependent agent. Since the server is a machine, it could not be a dependent agent within the meaning of Article 5(4) of the DTAA.

10.6 Virtual Permanent Establishment: This is a new concept of permanent establishment emerging in regard to digital economy. Madras High Court [in Verizon Communications Singapore Pvt. Ltd (2013)] remarked that the foreign enterprises do not need physical presence in a virtual world. [39 Taxmann.com 70]. Bangalore ITAT also concluded that service PE does not require PE as the service can be provided with various virtual modes like email, internet, video conference etc., without physical presence of the employees. (83 TM.com 86). Similarly (in 2016), in the case of Dell products, the Spanish Court held that the Company's income to be taxable in Spain on account of presence of a Virtual PE due to "economically significant activities" (*Spain vs. Dell case* No. 1475/ 2016 dt. 20.06.2016)

10.7 Significant Economic Presence: The conventional ways of situs based taxation failed

to capture the businesses run through digital media. One of the ways, OECD's Report [on BEPS Action 1, issued in 2015], recommended taxation of digital transactions was on the basis of 'Significant Economic Presence' (SEP). This concept has now found its place in Explanation 2A to Section 9(1)(i). Income attributable to any transaction in respect of any goods, services or property carried out by a non-resident in India, including provision of download of data or software in India, if the aggregate payments exceed the amount prescribed; or systematic and continuous soliciting of business activities or engaging in interaction with prescribed number of users in India, will be taxable in India on account of significant economic presence.

11. INCOME ATTRIBUTABLE TO PERMANENT ESTABLISHMENT

11.1 As per Double Taxation Avoidance Agreements, business profits of an enterprise of a contracting State are taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment. If the enterprise carries business as aforesaid, the profits of the enterprise may be taxed in the other State only to the extent attributable to the permanent establishment. The profit attributable to the permanent establishment is determined by imagining the permanent establishmentto be an entity independent of the foreign enterprise and dealing with the foreign enterprise at arm's length. There are no detailed guidelines in the tax treaties for quantification of profit attributable to the permanent establishment, even in a traditional commerce situation. Therefore, it causes practical difficulties in quantification of profits attributable to the permanent establishment.

11.2 In e-Commerce situations, where apart from traditional transactions like sale of goods and provision of services, an array of products and services can be transacted, it would be quite complex to determine the profit attributable to the permanent establishment. Therefore, a simple method like profit split method where total profit between the head office and the permanent establishmentis split, may be attempted and included under the Double Taxation Avoidance Agreements for quantification of the profit attributable to permanent establishment.

11.3 Arm's Length Principle Regarding Profits Attributable to P.E.: The Courts have consistently held that once arm's length principle has been satisfied, there can be no further profit attributable to a person even if it has a PE in India [*ADIT, New Delhi vs. Efunds, IT Solutions (SC)* (2017)]. Following this principle, the SC has also quashed issuance of reassessment notice [Honda Motors Co. Ltd., (March, 2018)]. As part of mandate of BEPS Action 7, OECD has also released its final document, in March 2018, on additional guidance on attribution of projects to PE.

12. OTHER ISSUES

12.1 Exchange of Information: India has a strong tax treaty mechanism with different countries under DTAA and TIEA. Information can be sought through FT&TR references from other countries about the beneficial ownership of shell companies, transactions and assets of Indian taxpayers. CBDT has also come out with a Manual on Exchange of Information which can be consulted while framing a reference. Under Global pressure to curb tax evasion many countries including tax havens have started providing information sought from them. Following the ICIJ and Panama leaks, the EOI mechanism has proved very useful for unearthing foreign bank accounts and assets of Indian tax residents. Further, information is also being received under Automatic Exchange of information and FACTA provisions which is being investigated by the AOs.

12.2 Black Money (Undisclosed Foreign Income & Assets) and Imposition of Tax Act 2015: Has come into force from July 1, 2015**.** It applied to both undisclosed foreign income and assets (including financial interest

in any entity). Undisclosed foreign income and assets are taxed at a flat rate of 30% at its fair market value in the previous year in which the asset comes to notice of AO. No exemption or deduction or set off of any carry forward losses is admissible. The penalty for violation is 3 times the tax payable. Penalty Failure to furnish return in respect of foreign income or an asset would be Rs 10 lakhs. It provides for prosecution also.

12.3 Multilateral Instrument under BEPS: This was proposed to put into effect tax treaties and the recommendations of BEPS. It has been signed by 78 jurisdictions including India and list 2365 treaties as covered tax agreements (CTA) i.e. agreements that would stand modified once MLI (Multilateral Instrument) is effective. India has notified all its comprehensive bilateral tax treaties as CTA. Countries like China, Germany and Mauritius have not notified their treaties with India and their tax treaties will have to be changed bilaterally through negotiations. MLI contains an article to deny tax treaty benefits if one of the principle purpose of transaction is to obtain treaty benefit. There are a variety of situations where tax treaties will need to be renegotiated despite MLI.

12.4 Equalisation Levy: In tune with OECD BEPS Project to tax e-Commerce transactions, the Finance Act 2016, inserted a separate Chapter VIII titled 'Equalisation Levy'. It provides for an equalisation levy of 6% to be deducted from amounts paid to a non-resident not having any permanent establishment in India, for specified services. The provisions come into effect from 1st June 2016. Any payments being made for the specified services provided on or after 1 June 2016 shall attract the equalisation levy. The CBDT has notified the Equalisation Levy Rules, 2016, which lays down the procedural framework for the compliances to be undertaken and appeals process to be followed for such levy. These Rules are effective from 1 June 2016. The statement of specified service is required to be furnished electronically in Form No. 1 on or before 30 June immediately following that financial year. Specified service means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other service as may be notified by the Central Government. This tax is only levied when the aggregate consideration for specified services exceeds Rs 1 lakh during a financial year.

12.5 Advance Pricing Agreement (APA) (u/s 92CC of Income-tax Act 1961): An APA is an agreement between the taxpayer and the tax authority on the pricing of future intercompany transactions in case of a rollback, it would also include past years. The taxpayer and tax authority mutually agree on the transfer pricing methodology (TPM) to be applied and its application for a certain period of time for covered transactions (subject to fulfilment of critical assumptions). Indian Rules allows unilateral, bilateral and multilateral APAs. An APA can be applicable for a period of five years, with the option of a rollback for up to four years. The Government's APA programme has been progressing well and it has signed APAs with complex profit split methodologies. There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible to apply. The APA mechanism is not available for domestic controlled transactions. Any type of international transaction can be covered under an APA, e.g., transactions involving transfer of tangible and intangible properties, cost sharing, provision and receipt of services, etc. APAs are also possible for international transactions with permanent establishments. An APA can be applied for both continuing as well as proposed transactions. The taxpayer may withdraw itself from the APA process at any time before an agreement is reached.

12.6 Secondary TP Adjustments (u/s 92CE of Income-tax Act, 1961): The provisions relating to "secondary adjustments" introduced by Finance Act 2017 are applicable in the case of primary TP adjustments made from FY 2016–17 onwards. These provisions are

primarily intended to ensure that profit allocations between the AEs are consistent with the primary TP adjustment. A "secondary adjustment" has been defined to mean an adjustment in the books of accounts of the taxpayer and its AE to reflect that the actual allocation of profits between the taxpayer and its AE are consistent with the transfer price determined as a result of primary adjustment. The primary adjustment is defined to mean the determination of the transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the taxpayer. The taxpayer shall be required to carry out the secondary adjustment where the primary adjustment to the transfer price was:

a. Made voluntarily by the taxpayer on its incometax returns
b. Made by the AO and accepted by the taxpayer
c. Determined by an APA entered into by the taxpayer with the Indian Tax Administration
d. Made as per the safe harbor rules framed under the Income-tax Act Or
e. Resulted from the resolution of an audit adjustment by way of the MAP under a double taxation avoidance agreement (tax treaty)

12.7 Interest Limitation Rules (u/s 94B of Income-tax Act, 1961): As per Action 4 of the OECD G20 BEPS project, a new Section to limit interest deductions has been introduced in the Income-tax Act by Finance Act 2017 applicable from the FY 2017–18. The said provisions are applicable to an Indian company or a permanent establishment (PE) of a foreign company in India (collectively referred to as "borrower") if the following conditions are met:

a. The borrower is engaged in any business or profession other than banking or insurance
b. The borrower incurs expenditure in the nature of interest or similar consideration exceeding Rs 1 cr in a Financial year
c. Such interest expense or similar consideration is deductible in computing the taxable income of business/ profession
d. The debt is issued by a non-resident AE of the borrower or by a third party lender but an AE either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender.

If the above conditions are satisfied, the "excess interest" shall not be deductible in computing the taxable income of the taxpayer. The "excess interest" is computed as the excess of 30% of the EBITDA of the borrower for the relevant financial year or interest paid/payable to the AE, whichever is less.

12.8 It is likely that many of the existing '**tax haven'** countries will capitalise on the improvement in international communications infrastructure and bandwidth, and will attempt to become major players in the Internet economy. The cost of establishing a Web shop is not prohibitive even less to relocate one to another jurisdiction with the result that many Web shop owners will be tempted to setup operations in such jurisdictions. This will result in a significant loss of revenue from 'mainstream' jurisdictions. For the same reason, online banks and other payment providers may be established in such tax havens, with the result that revenue collecting authorities will be unable to have access to vital information.

12.9 Finally, the Internet is expected to provide a high level of mobility for Internet businesses, highly skilled labour and capital. This is expected to result in tax driven migration of businesses to the Internet, and of the Internet businesses to low tax jurisdictions.

13. FUTURE TRENDS

13.1 e-Commerce is poised to take off in a big way. The digital economy is characterised by an unparallel reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multisided business models and difficulty of determining jurisdiction where value creation occurs. New ways of doing business may result in relocation of core business functions. The G20 finance ministers called on OECD to address Base Erosion and Profit Shifting. The OECD came out with the Action report. Based on the suggestions, several changes as discussed above have been made in Incometax Act, 1961. In future the scope of source taxation may increase to more number of areas and services. In this scenario, there are following areas, which deserve deeper consideration:

a. **Internet of Things:** The ability to connect any smart device or object over time to a network of networks is enabling the 'internet of things'. This includes machine to machine communication, cloud computing, big data analysis, sensors and actuators which lead to further development in machine learning and remote control. This will lead to autonomous machines and intelligent systems and robotic machines. This would facilitate the movement of business functions and intangibles from one country to another with ease to gain tax advantages. The number of devices connected to internet is expanding rapidly.

b. **Virtual Currencies (Bitcoin):** These are digital units of exchange not backed by government backed tender. They may be exchanges for real currencies or used to purchase real goods and services. They may lead to anonymous transactions and will be useful in tax evasion.

c. **Advances Robotics:** New connected and smart robots are changing manufacturing. Artificial Intelligence and cognitive computing can generate productivity lower prices and change the way businesses are being done.

d. **3D Printing:** will enable to bring manufacturing closer to customer. Manufacturers could license plans to third party manufacturers or even retailers. This increases the possibility of locating business activities at a location that is physically remote from customer.

e. **Sharing Economy:** Innovative sharing applications have emerged in respect of cars, spare rooms, food, clothes and private jets. Amateur providers have tendency to share their available resources at a lower price.

14. CONCLUSION

14.1 With rapid expansion of the Internet, global e-Commerce is going to assume a major dimension. The opportunities through e-Commerce will be available to both large corporations and smaller entities, without restriction of any geographical boundary. Apart from the traditional transactions like sale of goods and provision of services, there will be an array of products and services.

14.2 The OECD BEPS Report Action Plan 1 focussed on taxation of e-Commerce and digital economy. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no tax locations where there is little or no economic activity. The BEPS package provides 15 Actions that equip governments with domestic and international instruments needed to tackle BEPS. Countries now have tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. The digital economy is the result of a transformative process brought by information and communication technology. Some of the key features of Digital economy exacerbate BEPS risks.

14.3 Certain solutions have been proposed to address BEPS risks. This included modification of list of exceptions to definition of PE, introduction of antifragmentation rule, modification of definition of PE to include an agent who habitually plays the principal role in conclusion of the contracts and revised transfer pricing guidance that legal ownership alone generate right to all profits but group companies performing important functions will be entitled to appropriate return. It is expected that implementation of these measures and other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application of IP regimes of a substantial activity requirement with a 'nexus approach'), will substantially address the BEPS issues and aim an end to the phenomenon of socalled stateless income.

14.4 The BEPS report has strengthened the source based taxation and would mean more revenues for countries like India. Various options analysed for bringing to tax the digital economy included (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy. India has already adopted suggestions at point (i) and (iii). It would now have to modify its tax treaties to reflect the new norms. The adoption of Multilateral Instrument by India and its entry into force would open up a new chapter in the era of international taxation as measure to curb treaty abuse, treaty shopping and enable taxation in the country where value creation has occurred. There is going to be a lot of churning in both the area of domestic law and treaty law internationally and we need to keep ourselves and our laws updated to keep pace with these developments.

CHAPTER

4

Chain Stores and Supermarkets

1. CONCEPT OF CHAIN STORES/ SUPERMARKETS

1.1 In the present context, the model of supermarkets and chain stores are very popular in urban areas for shopping of textile, dress materials, household electronic goods items, furniture & fixtures and FMCG goods. The concept of supermarkets revolve around the idea of providing the convenience of shopping needs of the common public under one roof and it's growth is being driven by increasing affluence and the rise of a middle class. Initial development of supermarkets has now been followed by hypermarket growth. By way of making bulk purchase of various household goods and huge sales (turnover), the said supermarkets are able to pose major competition to the smallscale retailers.

1.2 The principal characteristics of the organized supermarkets/ chain stores are:

a. Centralized procurement and distribution system
b. Effective inventory control
c. Uniform/ unified administration and management system
d. Effective control over cash and card sales
e. Use of customized software for sales
f. Standalone accounting system, which is not linked to the sales software

The salient characteristics of the supermarket are discussed in detail for better clarity.

2. CENTRALIZED PROCUREMENT AND DISTRIBUTION SYSTEM

2.1 These entities are involved in bulk purchase of various household items through their centralized purchase system. Due to their huge turnover and high inventory ratio, the centralized procurement and distribution system provides economy of scale in purchases and operations for these concerns. Generally these purchases can be divided into two types:

a. Purchase of unbranded items like purchase of furniture and fixtures, unbranded

textile/ dress materials, agro commodities, household utensils and certain unbranded electronic items, etc,

b. Purchase of various branded items like purchase of branded furniture and fixtures, branded textile/ dress materials, and branded electronic items, etc,

2.2 Purchase of Unbranded Items: These concerns make direct purchase from the suppliers on bulk basis. Generally bulk purchases of unbranded household items like kitchen articles and utensils, plastic items and various agro commodities (food grains, oil, and other kitchen items) is made from the unorganized sectors at lesser price than the fair market rate. Further, for the said purchases, the assessee may make payments in cash below threshold level in order to avoid applicability of provisions of Section 40(3) of the Income-tax Act.

2.2.1 Further, it is also common that these concerns outsource supply to the third party manufactures for the supply of certain specific household items for the entire group. These third party manufacturers supply the required items directly to the various outlets of the assessee group, e.g. manufacturer of kitchen utensils/ articles and plastic items, etc.

2.2.2 It is also observed practice that most of the chain stores/ supermarkets are selling household items with their own brand name, particularly food items, kitchen articles, agricultural commodities and plastic items by way of their own packing and repackaging units located in the outskirts of the town.

2.3 Purchase of Branded Items: These concerns make direct purchase from the principal suppliers, distributors/ manufactures of branded items on bulk basis, e.g. textiles, garments, branded food items, electronic articles, etc, with huge price discounts. Further, the concern also enjoys reasonable credit period of, say, one month or so for its purchases. This enables it to sell the goods at less than the marked price/ maximum retail price. In view of the above, the concern does not need any significant working capital or assistance.

2.4 Hence, as discussed above, the centralized procurement and distribution system provides economy of scale in purchases and operations for the chain stores.

3. EFFECTIVE INVENTORY CONTROL

3.1 One of the important characteristics of these concerns is the proper and efficient distribution of goods to its outlets and internal control mechanism over the stock. Normally bar code used is given to all the packed items and kept in the store as stock. The stocks, which are kept in the warehouses, are not barcoded and hence, there is huge possibility of manipulation of actual stock visàvis the stock as per the books of account.

3.2 Usually, fast moving items is kept in the store with the required stock for less than a week. Once the stocks in the stores are sold out, the same is replenished immediately by moving the stock from its own warehouses. It is a notable feature that these concerns maintain a centralized warehouse or store, which is normally located away from the stores. There is also a possibility of maintaining secret warehouses, which is known only to some confidential persons of the management.

3.3 In the warehouse/ stores, these concerns adopt computerized control mechanisms to have proper control of the stock and inventories including packaging materials and other sundry items. This effectively checks pilferage by employees in the stores.

4. CUSTOMIZED SOFTWARE AND STANDALONE SYSTEM OF ACCOUNTING

4.1 In the showrooms/ stores, there is effective internal control system to monitor cash and credit card sales collections. Normally, sales are controlled by way of centralized computerized systems with the customized software (e.g. JILABA software in Chennai). At the end of each day sales, the sales list used to be generated by each billing person and handed over to the supervisor of the store and will be given to the management. The day sales used to be entered on weekly basis in the standalone accounting system for accounting purpose.

4.2 There is also a possibility that in some showrooms, these customized software may have certain features to delete or of not recording certain sales in a particular way, e.g. not recording the sales in certain frequency of transaction. Hence, there is discretion for the management to record sales in the standalone system. Thus, there are possibilities for the management to suppress sales in the books.

5. UNIFORM/ UNIFIED SYSTEM OF MANAGEMENT

These concerns have a uniform and unified system of administration. All sales outlets are made to adopt the same standardized pattern. In areas like trading, billing, accounting and packing, uniform procedures are followed.

6. AREAS FOR INVESTIGATION

The main modus operandi of these concerns is large procurements at heavily discounted prices and sales to customers at prices less than the marked price/ the MRP/ the local retail price. The discounted prices offered by these retailers attract lot of customers, resulting in huge sales and big profits. The areas of investigation in these concerns are discussed in detail as under.

7. DISCOUNTED PURCHASES

7.1 These concerns deal directly with the principal suppliers or manufacturers. Since purchases are made in bulk, the cost is low. In addition, the supplier gives cash discount and also turnover discount. These concerns gain substantially from these discounts. They enjoy large discounts and benefits from branded consumer items. It is a matter for investigation whether the discounts received are duly accounted for in its books.

7.2 These concerns procure at a discounted price. It also gets fairly long credit period for its procurements. Hence, their working capital requirements are minimal. Some of the suppliers could be shown as trade creditors in the books. As a normal practice, all trade creditor accounts should be scrutinized.

7.3 Suppliers normally do not charge interest from these concerns. The interest account needs scrutiny to rule out the possibility of any inflated claim of interest.

7.4 These concerns get dealership commission for bulk purchases. Such commission can go unaccounted or netted off with the payables of earlier years. To examine this aspect, the sales promotion account of the suppliers may have to be scrutinized.

8. ACCOUNTING OF COMMISSION

Generally, these concerns deal directly with the principal supplier on bulk basis. Hence, any commission payment to any intermediary is unlikely. However, some companies claim expenditure on this account. This is not the normal trade practice. Hence, scrutiny of such claims is called for.

9. MANUFACTURE OR PURCHASE

9.1 In many cases these concerns also manufacture some of the items, which are in great demand. Items like various varieties of papads and pickles, traditional sweets/ eatables (like snacks, sprillosprill), powders like dal powder, sambar powder, idli mix, dosa mix, snacks and condiments fall in this category. Some of these items are so good that they enjoy tremendous brand loyalty and customer confidence. These items are handmade. Only the input and labour costs are incurred. In order to suppress the taxable profits, the concern may resort to the subterfuge of showing the manufacture as purchase from the labourers. Such labourers for the sake of mere wages give sale bills. Huge margin/ profit is earned by supermarkets on this account. The AO should be alert to this possibility.

9.2 Some concerns purchase the items straight from farmers at low prices. As the sale price is not likely to be lower than that in other shops, their profit margin on these items is bound to be higher. In view of the above, purchases and sales of items like rice, wheat, chilies and tamarind need scrutiny.

10. MALPRACTICES IN SALES

10.1 These concerns issue bills for every sale, as it is necessary for their credibility and internal control. Still, all the sales effected may not find their way into the sales register or cash book by way of manipulation of sales ledger/ accounts.

10.2 Manipulation in billing machines is also a possibility. In cases of such manipulation two sets of sales reports are generated. One report reflects the actual sales made in a particular day. The report shows lower sales according to the concern's convenience. The second report is taken for the purpose of regular sales and entered in the regular books of account.

10.3 In certain concerns it was noticed that though there were billing machines, handwritten bills were also issued often. Such handwritten bills were prepared on small chits of paper and were not recorded in the books. This practice is followed in some outlets, which are manned and controlled by close relatives of the management.

11. GENUINENESS OF CLAIMS

11.1 These concerns often incur huge advertisement expenses and offer sizable discounts to customers. The discounts are given by way of various schemes like discount on sales (sales discount at the yearend sales/ festive seasons) and free gifts scheme, buy one and get one scheme, etc. There is possibility that these discounts are never passed on completely to the customers or there are possibilities of inflation of expenses by way of such schemes. The AO should examine thoroughly the claims of discounts and gift schemes before allowing the expenditure.

11.2 These concerns also offer gift schemes during festive seasons by way of gift items received from suppliers. These items sometimes are sold outside the books after the expiry of the gift scheme period. Investigation of the suppliers' accounts may help in bringing the escaped income to tax.

11.3 Advertisement is a major item of expenditure. But, these concerns do not necessarily bear the entire expenditure. Often the supplier chips in to bear the whole or part of the expenditure. Cross verification with suppliers' accounts may bring to light any bloated claim of advertisement expenditure.

12. TELEPHONIC ORDERS

Most of these concerns take orders over telephone and deliver the goods at the customers'

doorsteps. These items are often delivered directly from the warehouses. Generally separate accounts are maintained for this purpose. The concern may choose not to bring these sales into the books. This aspect should be kept in view and the relevant order books perused to rule out the possibility of omissions/ suppression of such sales.

13. INCOME THROUGH SHOWCASE WINDOWS AND DISPLAYS

These concerns receive considerable rent from consumer product companies for displaying their products in the show windows. The rent received varies according to the location at which such windows are displayed. Whether the incomes from renting and displaying of show windows are properly accounted for and whether proper documentation is available for these transactions these are the questions that should be asked and facts looked into.

14. INVESTMENT IN SHOWROOM FURNISHING & UNAUTHORIZED EXPENSE FOR SHOWROOM

These concerns often incur huge expenses for creating infrastructures in the showroom for the purpose of pleasant shopping experience of the customers. Hence these concerns pay attention for colour, surface texture, floor coverings, style, individual service counters, centralized airconditioning, lightings, visual communications and even use of aromatics in order to give a sense of supermarkets being healthy, fresh. Sometimes, these concerns create unauthorized structures in the showrooms either by way of making additional floors or additional rooms. Hence, there are possibilities of inflation of expenses by way of creating above additional infrastructures or incurs unexplained expenses for this purpose. The AO should examine thoroughly on the above expenses before allowing the expenditure.

15. VERIFICATION OF STOCK DURING THE SURVEY/SEARCH PROCEEDINGS

15.1 Like every other business super market also may resort to inflation of purchases and expenses and suppression of sales. Such attempts should be tackled in the same way as in a normal business case.

15.2 As discussed earlier, a major area for investigation in cases of supermarkets and chain stores is stock discrepancy. These concerns make bulk purchases of commodities like wheat, rice, pulses, cereals etc and repack them in smaller quantities to suit consumer needs. In view of the large number of items dealt in, it may be difficult to verify the stock with the concern. But, it is not impossible. Verification is always possible with reference to the closing stock inventory, which the assessee itself would have taken by the yearend. Getting the concern committed to its real stock as per its inventory is a tested way of tackling stock manipulations. This can be achieved by survey u/s 133A or enquiry u/s 142(2) soon after the yearend or end of the season sales.

15.3 The verification of stock of these concerns during the course of search or survey proceedings can be made by way of following approach:

a. The physical stock may be verified floor wise/ room wise under the supervision of particular person for the purpose of capturing the details of stock, viz, name of the item, type, quantity, rate/ piece or kg.

b. The staff of the store's showroom may be Utilised for the said purpose of verification of stock with effective supervision.

c. The following details related to the stock have to be ascertained on the day of search or survey proceedings:

   (i) Purchase materials received and updated in the stock register but not entered in the books of accounts because bills are not received.

(ii) Purchase bills received and entered in the books of accounts but materials not received.

(iii) Sales bills issued and entered in the books of accounts but material not delivered.

(iv) Materials delivered and reduced in the stock, but sale bills not entered in the books of accounts.

15.4 If the assessee is unable to correlate the physical stock available on the day of search/ survey with the relevant purchase invoices, the cost of the available physical stock as on the date of search could be ascertained by way of applying the tag price of the physical stock after reducing the average gross profit rate claimed by the assessee in earlier years. The said closing stock so arrived should be compared with actual closing stock available as per books and accordingly, the excess/ shortage of stock can be arrived.

15.5 The actual closing stock as per books as on the day of search/ survey can be worked out by considering the closing stock as on the previous yearend (i.e. closing stock as on 31st March), purchases and sales made during the intervening period (i.e. From 1st April of the relevant Financial Year to the date of survey).

16. RECENT TRENDS IN RETAIL MARKETING

16.1 *e*-Commerce/ Digital Marketing

In the present scenario, *e*-Commerce is growing rapidly in Indian subcontinent. *e*-Commerce/ Electronic commerce is the activity of buying or selling of products on online services or over the Internet. This draws on technologies such as mobile commerce, electronic fund transfer, supply chain management, Internet marketing. The Information Technology Act 2000 presently governs the basic applicability of *e*-Commerce in India.

16.2 The *e*-Commerce markets are growing at noticeable rates. The online market is expected to grow by 56% in 2015–2020. But, the traditional markets are only expected 2% growth during the same time. Traditional retailers are struggling because of online retailer's ability to offer lower prices and higher efficiency.

16.3 *e*-Commerce brings convenience for customers as they do not have to leave home and only need to browse website online, especially for buying the products which are not sold in nearby shops. It could help customers buy wider range of products and save customers' time. Consumers also gain power through online shopping. They are able to research products and compare prices among retailers. Also, online shopping often provides sales promotion or discounts code, thus it is more price effective for customers. Moreover, *e*-Commerce provides products' detailed information; even instore staff cannot offer such detailed explanation. Customers can also review and track the order history online. *e*-Commerce technologies cut transaction costs by allowing both manufactures and consumers to skip through the intermediaries.

16.4 *e*-Commerce allows customers to overcome geographical barriers and allows them to purchase products anytime and from anywhere. Traditional retailers offer fewer assortments of products because of shelf space where, online retailers often hold no inventory but send customer orders directly to the manufacture/seller. The pricing strategies are also different for traditional and online retailers. Traditional retailers base their prices on store traffic and the cost to keep inventory. Online retailers base prices on the speed of delivery. Online marketers can offer lower prices, greater product selection, and high efficiency rates. Many customers prefer online markets if the

products can be delivered quickly at relatively low price.

16.5 Logistics in e-Commerce is main concern. Online markets and retailers have to find the best possible way to fulfill orders and deliver products. Small companies usually control their own logistic operation because they do not have the ability to hire an outside company. Most large companies hire a Fulfilment service that takes care of a company's logistic needs.

16.6 This expenditure can be verified with the concerned logistic provider. Warehousing is generally in cheap real estate as no shop front needs to be maintained and the premises is primarily for storing goods. This expenditure can also be verified. Delivery cost will have a correlation with the number of items shipped.

16.7 Mobile devices are playing an increasing role in the mix of e-Commerce; this is also commonly called mobile commerce, or mcommerce. Many companies have invested enormous amount in mobile applications.

16.8 Further, heavy expenses incurred for advertisement of online business. Presently, modern 3D graphics technologies, such as Facebook and Google 3D posts, are considered by some social media marketers and advertisers as a more preferable way to promote consumer goods than static photos. This expenditure can be verified with the concerned advertisement Agencies.

16.9. Teleshopping

The model is built on reaching the consumers through advertisement on television networks. The success of the concept depends on ensuring that the product (which is given a model number) is available only through teleshopping and cannot be bought in neighborhood retail shops. A telephone number is given through which the company can be contacted and on receipt of an order, the product is door delivered.

16.10 In teleshopping model, the products are out sourced from various manufacturers. An exclusive arrangement is entered with the manufacturer that the products can only be sold through the teleshopping network. The cost at which the product is to be sold to the teleshopping network is also predetermined. The teleshopping network then adds its margin and keeps the product on its network. Teleshopping is also understood to mean shopping through telephone. An exclusive model did not develop in India as practically every retail shop provides such teleshopping service.

16.11 The main expenditure for a teleshopping network is the advertisement cost, warehousing cost and delivery cost. To minimise the advertisement cost, nonpeak hours bulk time is booked on TV channels. This expenditure can be verified with the concerned TV channel. Warehousing is generally in cheap real estate as no shop front needs to be maintained and the premises is primarily for storing goods. This expenditure can also be verified. Delivery cost will have a correlation with the number of items shipped.

16.12 With the advent of Internet and e-Commerce, teleshopping is suffering a setback. The basic disadvantage of teleshopping is that time when the product is shown on a TV channel is fixed and if the program is not watched at that particular time, there is no scope for orders. The Internet on the other hand is accessible at any time and at any place.

16.13 Direct Selling (Multilevel Marketing)

This model is built on making the consumer a distributor. A person signs up with the company (there may be a joining fee), buy a set of its products and start selling them to people. On the

way, the person also recruits other salespersons, who in turn are encouraged to recruit more salespersons. As more and more persons join the scheme, a pyramidal structure of sales persons will develop with the first person at the top. Commission is paid to the person on what he sells and also on what the pyramid under him sells. There are certain incentives and bonuses on reaching certain targets. Amway, Oriflame and Modicare are some of the pioneers in this line.

16.14 It is noticed that these companies do not spend much money either on advertisement/ brand development or on building distribution network. The initial products launched by these companies were all high priced and were exclusive products. They are selling products of daytoday use like soaps, toothpastes and kitchen items at rates comparable to normal market rates for comparable products.

16.15 Like any other FMCG company, these companies also outsource their products. The main expenditure for these companies is the commission payments to members. The commission system and incentive system of these companies should be studied properly so that correlation can be arrived between quantum of sales and the commissions shown as expenditure. It is also a fact that some of the memberdealers of these companies make good money. These memberdealers are normally ordinary middle class people who may not be in the tax net. A list of the memberdealers should be collected and passed on to officers of concerned jurisdiction, which will help in widening the tax base.

17. DISCOUNT RETAILING

17.1 What is Discount Retailing (DR)

India is an extremely pricesensitive market. The marketing strategy that pays here is to compete on price. Packaging, shop displays, airconditioning, piped music are all secondary. Indian customer is partial towards low prices. This penchant for value shopping has given a boost to discount retailing.

17.2 DR can take on many forms. Rent a hall. Display your wares. Announce good discounts. Minus the trappings of a super store or the friendly permanency of the neighbourhood grocer, one would expect the venture to fail. But, no. The sale clicks. If the quality of your wares are any good, you make good sales. For an existing retailer DR opens up new avenues. If he goes for new premises, he would have to pay huge rent. He would have the tensions of running it all the time. With a hall, there is just the cost of renting the hall and advertising, that too, for short periods of his choice. Such sales could be held in different areas and cities. There are even retailers who operate almost entirely in this mode. They simply shift between hired halls in different parts of the city. They rely on ads and mailing lists to keep customers informed of this constant, peripatetic sale.

17.3 Any manufacturing process, no matter how good, throws up reject goods. They cannot be sold as firstquality products through showrooms. They need to be sold at some price. This is achieved through a seconds sale or a factory outlet. 'Seconds' also include perfect products that cannot be sold because of excessive stock or lack of demand in those sizes, or close outs which are the products on the shelves but which have gone out of fashion. They can be sold through sales or dedicated seconds outlets. The latter course is preferred by the companies because it disposes of the products in an organised and continuous way. There are de facto 'seconds' shops and areas in most cities.

17.4 'Sale', as DR is ordinarily called, has already shown its strength. A well known book store's 'sale' in Mumbai in a hall not far from the store this year fetched nearly 4,61,000 visitors

over 15 days and added significantly to the shop's turnover. The shop is considering more sales in the year and holding them in different areas or other cities. An innovative retail format put through by some Chennaibased concerns has proved a great success. Through a combination of bulk purchasing, streamlined inventory management, low overheads and aggressive marketing, they manage to allow 10–15 per cent discount on nearly all their sales. They effect savings from supplychain integration and use the savings to fund investments in developing large retail formats like supermarkets or pass them on to the customer in the form of discounts.

17.5 The mainstream marketers do not rate DR highly, at least not yet. They do not view it as a proper retailing channel. The informal atmosphere of a 'sale' puts them off. There are fears of DR sales undercutting the brand. Their reasons: In DR there are difficulties in estimating size. DR ventures are impermanent ('sales', fairs). They are mere waste disposal enterprises (Seconds outlets). Often, they are on the fringes of legality (grey market shops). Maybe there is some substance in this belief, but there are overwhelming reasons recommending DR. DR is a format that does not need prime locations or plush interiors. It still attracts in customers. The success is due to two factors one, economic (lower prices) and, two, psychological (the satisfaction consumers get from a bargain). It may not be a bargain at all, but the customer feels it is. Besides, the Indian housewife needs the reassurance of having made savings to assuage her feelings of guilt at spending. DR does this trick.

17.6 The fast moving consumer goods (FMCG) market is facing threat from both counterfeit products and pass off products. Counterfeit products are fake products. They bear identical names, packaging, graphics and colour scheme. They even have the genuine manufacturers address printed on. They are like fake currency notes. Passoff products are lookalikes of genuine products. They use names which sound similar or are similar in spelling. The counterfeiters have grown versatile making it difficult for consumer goods industry. The counterfeit and passoff products trade has reached critical levels and the size and severity of counterfeiting in India has no parallel. It is seen that in the sphere of DR, especially in the form of hall sales, pass off products are being sold in large numbers. Thus, while the unsuspecting consumer is taken for a ride, the genuine product manufacturer is cheated of his market share.

18. OUTLOOK

18.1 International discounters may use discounts to revolutionise the Indian market. The Indian discounters like Subhiksha of Chennai claim that they are already doing that. Informal channels of sales and related activities represent a DR sector that is already wellentrenched and highly successful. They are increasingly taking on a formal status. Markets for exportreject clothes or grey market goods like Chennai's Burmah Bazar are now permanent and important sources for goods. Local laws registering hawkers and informal shops and international treaties like the WTO which lower import duties thus giving legitimacy to grey market products are all favouring DR. From all angles of size, importance to customers, competition to legitimate players and now even legal status, these channels have emerged as viable entities. Manufacturers who had been skeptical about a discount channel now see it as a strategic opportunity.

18.2 Innovative DR has good potential. In just 4 years the Chennai group Subhiksha has grown to be formidable with 83 outlets across 12 cities with a turnover of 12.3 crores per month. The other groups are planning discount formats aimed at small retailers and large family customers. Hypermarkets with a large store

offering a wide range of products at value prices and the cash and carry format are getting ready. But it is not roses all the way. The success stories have all been in the metros with their large base of affluent customers. Smaller towns with less affluence are bound to be, and in fact are, more pricesensitive. The DR sellers are already finding the going tough in small towns.

18.3 Coming to tax implications and investigations, many of the 'halltype' discount retailers are really small people making a living out of the 'sales'. Any detailed investigation may not be necessary in such cases. In the more organised cases, similar investigations as in the cases of other retailers' may be conducted. However, it should be kept in mind that in DR cases the usual norms regarding profit margins cannot be applied. Here, the profit margin is bound to be low. The profit lies in the large turnover. The investigative effort should be in the direction of determining the turnover. In the case of counterfeits and passoff goods, investigations at the manufacturer's end will help develop the cases of both the manufacturer and the retailer. Initial information about the identity of the manufacturer is to be gathered through enquires with the retailers.

CHAPTER

5

Newspapers and Journals

1. INTRODUCTION

1.1 India is considered to be the world's largest newspaper circulation market. As per the Registrar of Newspapers for India, there were about 16,000 registered newspaper dailies and about 94,000 periodicals listed with it as of 31/03/2016.

1.2 The newspapers/news related journals get their information from various sources. The primary source of any news is of course the firsthand reporting done by journalists. These are the people on the ground who report from the scene of the specific incident/event. Since newspapers/journals cannot have reporters all over, they depend on wire services/news agencies for their news. Some of the major news agencies include UNI, PTI, Samachar Bharati, Asian News International, PIB etc. and the wellknown international news agencies are Associated Press, Reuters, Xinhua, ITARTASS etc. Another source of news is from media releases sent out by businesses, industry, government and other groups. These releases are often rewritten and fact checked by the newspapers/journals. The newspaper also utilises the services of freelancers or casual reporters who contribute for niche coverage areas or for doing supplemental work. For complicated or technical issues, the newspaper may seek outside help from experts in understanding and explaining the issues at hand. With the advent of the Internet, most of the leading newspapers and journals are now available on the net, in the form of websites and they source news from news aggregator sites also. A news aggregator is a client software or a web application which aggregates syndicated web content. The news aggregators gather data from news websites, RSS feeds and some like Google News visit any link on a news website and crawl whole HTML pages. The news aggregators extract the relevant part of the news and summarise the same for easy viewing.

1.3 The entire process of news reporting involves layers of reporting, editing and more reporting to build the news that go into a single issue. The bulk news is collected, segregated, composed and then edited by the editorial department. After proofreading it goes for printing. The entire process of newsgathering and printing has been revolutionized with the advent of computers and network connectivity.

2. INDUSTRY STATISTICS

2.1 The calendar year revenue data (Segmentwise and excluding digital mediums) indicates that in this industry is dominated by the newspaper segment as under:

Table 1: Segmentwise Revenue Growth

(INR billion)

Segments/Year	2014	2015	2016	2017	2018	Growth in 2018	CAGR (2014–2018
Newspaper revenue	234.3	254.0	274.1	295.0	306.4	3.9%	6.9%
Magazine revenue	13.8	14.3	14.2	13.3	12.5	6.0%	2.4%
Total print market	248.1	268.3	288.3	308.3	318.9	3.4%	6.5%

Source: KPMG

2.2 All over the world, the physical newspapers/ journals are losing ground to the electronic media but in India the Newspapers segment display a growth trajectory. Though niche magazines and local/regional magazines continue to attract readership the traditional magazine segment is declining due to competition from television and Internet. Many magazines now have a digital presence. The growth in newspaper segment is on account of the rising literacy levels, increased circulation of regional language newspapers and the consequent localisation of content as well as advertisement revenue. Still, the overall trend indicates that the growth in recent years is tapering down.

2.3 In 2018, the circulation of Hindi language newspapers had grown by 6.5% over 2017 followed by the Regional and English newspapers which grew @ 4.2% and 1.2% respectively. This can be seen seen from the Table below:

Table 2: Year-on-Year Language Wise Circulation Revenue

(INR billion)

Languages	2014	2015	2016	2017	2018	Growth in 2018	CAGR (2014–2018
English	29.4	31.1	32.6	33.9	34.3	1.2%	3.9%
Hindi	26.7	29.9	33.3	36.7	39.1	6.5%	10.0%
Other regional languages	26.0	27.7	30.2	33.4	34.8	4.2%	7.6%
Total print market	82.1	88.7	96.1	104.0	108.2	4.0%	7.1%

(*Source:* KPMG)

2.4 The major source of income for the newspapers/ journals is 'advertisement' revenue and 'circulation' receipts. With the advent of the Internet, most of the leading newspapers and journals are now also available on the net in the form of websites and advertisements have become the mainstay of such business. The 'circulation' of a newspaper/ journal can be defined as the average number of copies sold and distributed per publishing day. It is also referred to as the cover charge. As compared to the circulation revenue, the receipts of newspapers/ journals from the advertising stream are much higher. This can be seen from the calendar yearwise data of the Industry (excluding digital mediums) as under:

Table 3: Revenue Streamwise Growth

(INR billion)

Year	2014	2015	2016	2017	2018	Growth in 2018	CAGR (2014–2018)
Advertising	166.0	179.6	192.2	204.3	210.7	3.1%	6.1 %
Circulation	82.1	88.7	96.1	104.0	108.2	4.0%	7.1%
Total Overall	248.1	268.3	288.3	308.3	318.9	3.4%	6.5%

(*Source:* KPMG Reports)

2.5 The advertisement income is directly correlated to the circulation figures. The newspapers/ journals which have larger circulation are in a position to command higher rates. In India, the circulation of the newspapers/ journals is certified by the Audit Bureau of Circulation/Registrar of Newspaper in India and the circulation affects the advertisement revenue, both from the Government side e.g. the Directorate of Advertising & Visual Publicity (DAVP) and from the other advertisers. The Print Media Advertisement Policy, 2016 of Government of India has classified Newspapers/ Journals in three categories namely, Big, Medium and Small. A newspaper with a circulation of more than 75000 copies per publishing day is a 'big newspaper', one with a circulation between 25001 and 75000 copies per publishing day is a 'medium newspaper', and a newspaper with circulation upto 25000 copies per publishing day is a 'small newspaper'. The policy framework details circulation verification and other procedure for empanelment of Newspapers/ Journals with the DAVP. The procedure involves certification by RNI/ABC if circulation exceeds 45,000 copies per publishing day; for circulation upto 45,000 copies per publishing day certificate from Cost/Chartered Accountant/ Statutory Auditor Certificate/ABC is mandated.

2.6 It is also a fact that the cost of printing and publishing of newspapers/journals is higher than their cover charge. The newspapers/journals are priced at a low rate which further ensures their dependence on advertising. These features are captured in the following table:

Table 4: Year-on-Year Language Wise Advertisement Revenue

(INR billion)

Languages	2014	2015	2016	2017	2018	Growth in 2018	CAGR (2014–2018)
English	63.2	66.2	69.2	71.6	72.8	1.7%	3.6%
Hindi	50.7	55.5	59.8	64.3	66.6	3.6%	7.1%
Other regional languages	52.1	57.9	63.2	68.4	71.3	4.2%	8.2%
Total print market	166.0	179.6	192.2	204.3	210.7	3.1%	6.1%

(*Source:* KPMG)

3. RELEVANT ACTS AND ORGANISATIONS

3.1 The Press and Registration of Books Act, 1867: The Press and Registration of Books Act, 1867 (the Act) was brought on statute by the then British government to regulate printing presses and newspapers, to preserve copies of books and periodicals containing news printed in India and for the registration of such books and periodicals containing news. As per this Act, a 'newspaper' is defined as 'any printed periodical work containing public news or comments on public news'. The Act mandates that every book or paper printed within India shall have legibly printed on it the name of the printer and the place of printing, and (if the book or paper be published) the name of the publisher, and the

place of publication. The term 'Book' includes every volume, part or division of a volume, and pamphlets, in any language, and every sheet of music, map, chart or plant separately printed. The term 'Paper' means any document, including a newspaper, other than a book. The above Act also mandates that no person shall, within India, keep in his possession any press for the printing of books or papers or newspapers unless proper declarations are made in this regard before the concerned Magistrate. The Act also mandates that every copy of every such newspaper shall contain the names of the owner and editor thereof printed clearly on such copy and also the date of its publication. The printer of every newspaper in India is required to send two copies of each issue of newspaper as soon as it is published to the Registrar of newspapers for India. Similarly copies of the whole of every book printed in India is also required to be delivered to the notified officer.

3.2 Registrar of Newspapers for India

3.2.1 The Office of the Registrar of Newspapers for India, more popularly known as RNI, came into being on 1st July, 1956. The Press and Registration of Books Act contains certain statutory duties and functions of the RNI, which include:

a. Compilation and maintenance of a register of newspapers containing particulars about all the newspapers published;

b. Issue of Certificate of Registration to the newspapers published under valid declaration;

c. Scrutiny and analysis of annual statements sent by the publishers of newspapers every year under Section 19D of the Press and Registration of Books Act containing information on circulation, ownership etc;

d. Informing the District Magistrates about availability of titles;

e. Ensuring that newspapers are published in accordance with the provisions of the Press and Registration of Books Act 1867 and the Rules made there under;

f. Verification under Section 19F of the Act, of circulation claims furnished by the publishers in their Annual Statements; and

g. Preparation and submission to the Government on or before 31st December each year, a report containing all available information and statistics about the press in India with particular reference to the emerging trends in circulation and in the direction of common ownership units etc.

3.2.2 The nonstatutory functions of RNI include:

a. Formulation of Newsprint Allocation Policy i.e. Guidelines and issue of Eligibility Certificate to the newspapers to enable them to import newsprint and to procure indigenous newsprint;

b. Assessing and certifying the essential need and requirement of newspaper establishments to import printing and composing machinery and allied materials.

3.2.3 In view of its functions and powers, the office of RNI is an important resource for obtaining information about various newspapers and journals. The RNI receives circulation data from the publications through prescribed annual returns. This circulation data is used by various Government departments, including DAVP for deciding on allocation of government advertisements and by the RNI for issue of eligibility certificate for import of newsprints etc. These returns/reports are certified by the Auditors/Chartered Accountants of the publishers. The RNI, on request of the publisher or suo moto or on the receipt of complaints, carries out sample check/verification of the circulation data submitted by the publishers. The circulation check is done by the team of RNI/ PIB and DAVP officials nominated by the Press Registrar for this purpose along with auditors (i.e. Chartered Accountants' firms) who are either on the panel of ABC, CAG and RBI. The objective

of the said circulation check or verification is to reconfirm the correctness and genuineness of the circulation data/figures submitted by the publications in their annual returns/reports. The office of RNI has recently issued a Circular No. Cir/60/2016–17/NPCS(Pt.) dated 31.10.2018 as per which the publishers/owners need to give a selfdeclaration regarding printing details at the time of a Press Visit by the officers of RNI. The prescribed format of this selfdeclaration includes details of the printing machines and other machines installed, their printing capacity, print order etc and also has details of payment of GST on purchase of newsprint/consumables as well as details of newsprint consumed. These details may be of relevance to the assessing officers also.

3.2.4 Recently the office of the Directorate General of Foreign Trade under Ministry of Commerce & Industry has directed that the newsprint imports can be made only for actual users holding registration certificates from RNI. Such newspapers are allowed to import without an import license subject to submission of necessary documentary evidence, duly authenticated by the RNI, to the satisfaction of the Customs authorities at the time of import of goods. In addition, such importers are also required to submit an annual audited statement reflecting the total quantity and value of the newsprint consumed and quantity of newsprint imported by them in the preceding (Licensing) year to the Registrar of Newspapers for India, by 30th April of each year. All this information can be of use to the assessing officers.

3.2.5 The RNI has its own webpage and email address. Presently, the office of the RNI is located at:

Office of Registrar of Newspapers for India,
Ministry of Information And Broadcasting,
9th Floor, Soochna Bhawan, CGO Complex,
Lodhi Road,
New Delhi – 110003

3.2.6 The field offices of RNI have been shut down since the year 2016 and the assets of these offices have been made part of the respective state headquarters of the Press Information Bureau. Simultaneously, the officers of Press Information Bureau posted in different State Units have been designated as officers under RNI also, as the case may be.

3.3 Audit Bureau of Circulations

3.3.1 Another important organisation in the field of Newspaper/Journals is the Audit Bureau of Circulations (ABC). It has its own webpage at www.auditbureau.org. This Bureau certifies the language wise certified circulation figures also. It was founded in 1948 as a notforprofit, voluntary organisation consisting of publishers, advertisers and advertising agencies as its members. It develops audit procedures to certify the circulation figures of member publications. The main function of ABC is to evolve and lay down a standard and uniform audit procedure by which a member publisher shall compute its qualifying copies. The circulation figure so arrived at is checked and verified by a firm of chartered accountants which are empanelled by the ABC. It also issues a certificate every six months to those publisher members whose circulation figures conform to the rules and regulations as set out by it. These circulation figures are an important tool and are critical to the advertising business community. Presently its membership includes 562 Dailies, 107 Weeklies and 50 magazines plus 125 Advertising Agencies, 45 Advertisers & 22 New Agencies and Associations connected with print media and advertising. It covers most of the major towns in India. Its headquarters is at Mumbai.

3.3.2 As per ABC, the languagewise circulation figures of various daily and weekly newspapers and magazines for the Audit Period Jan Jun 2018 was as below and this information can be of use of the assessing officer also:

Table 5: Languagewise Circulation Figures for the Audit Period January-June 2018

Language	Daily Newspapers		Weekly Newspapers		Magazines	
	Jan–Jun 2018		Jan–Jun 2018		Jan–Jun 2018	
	Numbers	Editions	Numbers	Editions	Numbers	Editions
Assamese	247,803	10	14,201	1	31,459	2
Bengali	2,735,435	9	338,747	1	386,617	5
English	7,365,752	110	3,444,868	82	176,398	4
Gujarati	991,469	10	59,248	1		
Hindi	* 20,681,913	184	2,289,376	20	407,154	4
Kannada	2,485,969	44			220,365	8
Khasi	27,990	1				
Malayalam	4,557,507	37	322,376	1	1,274,539	11
Manipuri	140,994	3				
Marathi	2,649,274	25	364,033	4		
Nepali	34,074	1				
Oriya	576,845	3			48,345	1
Punjabi	723,321	8	102,002	1	57,064	1
Tamil	2,639,926	27				
Telugu	3,990,331	71			426,403	4
Urdu	119,503	4				
Total Copies Certified	* 49,968,106	547	6,934,851	111	3,028,344	40

(*Does not include circulation figures of Dainik Bhaskar Gaya & Patna Editions.)

3.3.3 Similarly, in respect of the annual publications, the languagewise certified circulation figures for the Audit period January–June 2018 was as under:

Table 6

Language	Annuals	
	Jan–Jun 2018	Publications
Hindi	869,954	2
Kannada	30,665	1
Marathi	5,701,750	2
Total copies certified	6,602,369	

3.3.4 The Audit Bureau of Circulations also certifies the highest circulated publication (across languages) and the relevant figures for the period Jan–Jun 2018 were as under:

Table 7

Sr. No.	Title	Language	Average Qualifying Sale
Daily Newspapers (amongst member publications)			
1	Dainik Bhaskar #	Hindi	* 4,251,236
2	Dainik Jagran #	Hindi	4,144,706
3	The Times of India #	English	2,826,164
4	Hindustan #	Hindi	2,625,343
5	Amar Ujala #	Hindi	2,610,784
6	Malayala Manorama	Malayalam	2,368,672
7	Eenadu	Telugu	1,807,998
8	Daily Thanthi	Tamil	1,525,526
9	The Hindu #	English	1,397,944
10	Mathrubhumi	Malayalam	1,363,931
11	Daily Sakal	Marathi	1,204,640

Table 7. Contd...

...Table 7. Contd

12	Punjab Kesari	Hindi	1,165,506
13	Sakshi #	Telugu	1,091,079
14	Ananda Bazar Patrika#	Bengali	1,080,478
15	Patrika #	Hindi	1,005,485
16	Hindustan Times #	English	1,004,110
17	Dinamalar #	Tamil	848,287
18	Prabhat Khabar	Hindi	829,982
19	Divya Bhaskar #	Gujarati	822,513
20	Vijayavani #	Kannada	760,738
Weekly Newspapers (amongst member publications)			
1	Ravivasriya Hindustan #	Hindi	2,289,376
2	The Hindu #	English	1,079,938
3	Sunday Times of India	English	1,053,164
4	Ravivar Loksatta	Marathi	364,033
5	Karmasangsthaan	Bengali	338,747
Magazines (amongst member publications)			
1	Vanitha	Malayalam	406,957
2	Annadata	Telugu	316,470
3	Grehlakshmi	Hindi	303,886
4	Malayala Manorama	Malayalam	280,130
5	Saptahik Bartaman	Bengali	144,814

*(*Does not include circulation figures of Dainik Bhaskar Gaya & Patna Editions # includes variant copies*

3.3.5 The Audit Bureau of Circulations also certifies the highest circulated daily publication and various other figures which can be obtained by the assessing officer.

3.4 Indian Readership Survey: The Industry and the Advertisers are nowadays relying more on surveys of readership like the 'Indian Readership Survey, 2017' which reports the top publications in terms of readership. The important distinction is that while the ABC/RNI gives data only in respect of publications registered with them and they provide only circulation figures, the Indian Readership Surveys is more concerned with number of readers and its data has relevance to the advertisers.

4. INDUSTRIAL SEGMENTS

4.1 The newspaper industry can be grouped into three major segments

a. Major national newspapers and journals which are highly profitable

b. Major regional and vernacular newspapers/ journals that are either moderately profitable or at least, manage to keep themselves afloat.

c. Small newspapers/ journals which are finding it very difficult to operate owing to stiff competition.

4.2 The newspaper growth is mostly coming from papers published in Hindi and in other local languages and dialects popularly known as "vernacular" papers. According to the research, advertisement revenues for English language papers grew 3.5% in 2016, compared with 7.1% for Hindi language papers and 8.7% for those in regional languages. English is really only prevalent in India's largest cities, leaving readers in smaller cities and rural areas with an appetite for content in their local languages. The same trend is also evident from the data of Audit Bureau of Circulation.

4.3 According to an Audit Bureau of Circulation (ABC) report (May 2017), India has bucked the global trend of declining readership of print media. Newspaper circulation in India has grown from 39.1 million copies in 2006 to 62.8 million in 2016 – a 60 per cent increase. Comparable data for the most recent year available, 2015, show that while newspaper circulation grew by 12 per cent in India, it fell in almost every other major media market: by 12 per cent in the UK, 7 per cent in the US and 3 per cent in Germany and France.

5. THE ECONOMICS OF NEWSPAPER/ JOURNALS

5.1 Costs

5.1.1 Raw Material Costs: The Indian newspaper industry imports more than 50% of its paper requirement from the US, Russia and Canada. The price of the imports is sensitive to general economic trends like the crude oil prices (which impact the shipping rates), depreciation of the Indian rupee etc. As per CRISIL, newsprint prices have gone up from INR 36,000 per ton in FY 2016–17 to INR 55,000 in FY 2017–18 due to the depreciation of Indian rupee. The cost of producing a newspaper or magazine also depends on the number of pages, the extent of color used, the quality of paper, circulation figures and the degree of competition in the market among several factors. These could change from year to year.

5.1.2 Production/ Printing Costs: These are variable costs which vary with the size of the print run. Newsprint forms 50–60 per cent of the production cost. As a result, the more the number of copies printed, more cost is incurred unless every jump in circulation fetches an increase in advertising revenues that is more than or equal to the rise in printing costs. Typically, the advertising revenues subsidize the real price of newspapers while the trade commission to the vendors is constant. In certain years where the ad spend on print grows slowly, there was no incentive for newspapers to invest in circulation as it would eat into their profits. Many newspapers and magazine companies deliberately cap circulation. It is routine for publishing companies to drop in and out of ABC (Audit Bureau of Circulation) in the years when newsprint costs are high. Those are the years they do not like to spend more by increasing their circulation. A distinction has to be made here between the vernacular language and English dailies. Paradoxically, though the former reaches a less affluent audience, their cover price is higher. This is because even with higher circulation, the ad rates they can command are significantly lower than those for English newspapers. The actual proportion varies across brands, languages and regions. The English newspapers usually get anywhere between 25–50 per cent more on cost per thousand, according to one estimate.

5.1.3 People Costs: Newspaper is the only industry in the Indian private sector where a government appointed Wage Board fixes the wages of the employees. The last major revision was done in 2014. Roughly, people costs vary between 12–20 per cent of revenues depending on whether it is English or an Indian language publication.

5.1.4 Marketing Costs: This is a new imperative in the age of multiple editions and multimedia competition. To ward off competitors within print and from TV, radio or other media, it is crucial that a brand creates its own identity. These costs also include cost of soliciting advertisement and producing advertising copy.

5.1.5 Distribution Costs: This includes trade margins and the cost of returns or 'unsold' paers/ magazines. The hawker who collects the money from readers' homes usually pays the salaries of his delivery boys. The hawker, in turn, makes anything between 18–25 per cent on the cover price of the newspaper and this is negotiated through their union leadership also. The commission could vary according to the publication, the area, the city and the norms available there. It could be significantly higher if the newspaper or magazine is not an ABC member and, therefore, not subject to its rules. The unsold paper/magazines are a regular part of the business; the average volume of returns varies between 1–5 per cent depending on the city and its trade norms in the case of newspapers. In magazines, the unsold print run could be as high as 10–25 per cent, moving progressively upwards as the frequency of magazines increases. It is interesting to note that the Audit Bureau of Circulations also fixes the waste rate of Newspaper for its members. As per

its Notification No. 851 dated 14th May 2018 for the audit period July 2018 to December 2018 (applicable to all daily & weekly newspapers) the ABC's Council has adopted the value of waste at Rs. 10 to Rs. 11 per kg (regionwise) for all newspaper publisher members for the purpose of calculating the Net Realisation Rate.

5.2 Revenues

5.2.1 Revenues: The Revenues for Newspaper/ Journals come from circulation, advertising, subscriptions, brand extensions and internet/ mobile/ apps. It is to be noted that newspapers in India are priced low or coupled with discounts or complimentary supplements/ additions thereby making price a nonissue for the reader. The intention of the newspaper publishers is to build a loyal readership base which can be targeted by the advertisers. The more popular a newspaper, the larger its circulation in turn, the greater its utility as an advertising medium. This is the reason why various newspapers and journals claim high circulation (based on various surveys/sources) and also gave wider publicity to the awards received from various organisations.

5.2.2 Circulation: This is brought in from the cover or retail price of a magazine or a newspaper after deducting trade margins and the cost of unsold copies. The ratio could change depending on a number of things circulation, language, price and frequency of publication.

5.2.3 Advertising: The bulk of a publication's revenues come from advertising and this could vary by language, frequency, price, the market it addresses and so on. The best way to look at ad growth is to look at both, the advertising rates and volumes. Invariably, newspapers and magazines are being sold at less than the cost of production and the difference is contributed only by advertisement revenue.

5.2.4 Subscriptions: Some magazines like India Today or Outlook etc have highprofile subscriptions schemes. Earlier, these were treated as a revenue stream. The fact is that most subscription schemes are often subsidized with free gifts. They also involve cost of more copies to be printed, transported as well as the cost of marketing the subscription offers. Essentially, the subscription schemes are really about buying circulationunless the magazine is actually making a profit on every additional copy sold to the subscriber. Most subscription schemes are used to ramp up circulation numbers and demand a higher rate from advertisers.

5.2.5 Brand Extensions: There are several ways in which a magazine or newspaper can extend their brand to tap into different revenue streams. These may include events, TV programs, compact discs, seminars, roundtables, syndication of content and educational programs. This is especially true for specialized magazines or newspapers.

5.2.6 Internet/ Mobile/ Apps: Most Indian newspapers and magazines have been ramping up their internet and mobile presence to generate revenues using their original content. This income is through advertising at present.

5.2.7 Other Incomes: There are also miscellaneous incomes such as sale of syndicated articles and features, sale of waste newspaper, drums, unused ink, aluminium plates, etc.

6. ONLINE NEWSPAPERS

6.1 According to an Audit Bureau of Circulation report (May 2017), the advertising revenue through digital advertising is projected to grow by 30% CAGR (2016–2021) against 8% CAGR (2016–2021) in case of the print medium. The online newspapers/journals have grown on the back of mobile connectivity and Internet penetration. Some relevant online statistics are compiled by the Indian Readership Survey, 2017 as well as by Comscore.com. The Comscore Report on Digital Consumption, 2017 mentions

the growing digital population in the age group of 15–34 in India which has also led to increased consumption of digital news e.g. InShorts, Google Newsstand etc.

6.2 It was originally feared that television would be a major challenge to the printed paper and would replace it as the principal advertising medium. These fears have vanished. Though television has made inroads into the advertising domain, the newspapers have held on their own. The share of the newspaper is nearly 50 per cent of the total cost spent for advertisement in India. With the onset of internet, a webbased newspaper is a bigger challenge to the printed paper. The economics of such a newspaper will have many favourable points. An online paper can be run at a fraction of the cost of the printed paper. The saving will be on many items, the chief among them being the newsprint. The circulation costs will dwindle drastically. The online paper has several advantages. It is searchbased. By keying in the search word, the reader can find the story. A news story once hosted stays on forever. The online paper can be updated round the clock. There is no constraint of space for that paper. The online paper can travel considerably beyond news and provide valueadded services. The online papers give delivery of news a new dimension and change the way in which news is transmitted. It is also user friendly with the smart phones and high speed internet connectivity. Considering the global trend, 8% increase in advertising revenue of print media shows sound health status of the print medium in India and there is no immediate threat to the Print; however, the digital mediums will continue to grow at high rate.

6.3 The major differences between the financial aspects of the business models of an enewspaper and the traditional newspaper are summarized as under:

e-Newspaper	Traditional Newspaper
• No printing costs • Little distribution costs • Costs for running website and application • Lower income from advertising. • Income from central newspaper seller	• High printing costs • High distribution costs • Higher income from advertising • Income from newsstand.

7. TAX INVESTIGATIONS

7.1 The advertisement revenues are linked to circulation of the newspapers/journals and since more circulation means more fixed costs, some newspapers/journals may not be actually printing the desired numbers in order to save on production costs. However, if the newspapers choose to inflate their circulation figures, the corresponding production costs of such inflated sales would then be claimed by them without being actually incurred. In such a scenario there would be serious tax implications.

7.2 It is also to be noted that the per centage of newsprint cost in the total revenue has been increasing over the years and since the newspapers are sold at rates which are less than the cost of production, the difference is made up by advertisement revenue. It may not be worthwhile to compare newsprint cost visavis the total cost of production or visavis sales revenue from the sales of newspapers. Also, it may not be worth its while to attempt any addition on the basis of excessive wastage unless there is a glaring discrepancy in the wastage claimed as compared to earlier years figures.

7.3 Suppression of Advertisement Revenue: On account of competition most newspapers and journals are unable to charge at the rates fixed by them in their tariff card. Invariably, big discounts are allowed to the advertising agencies. These merit investigation. Further, the discounts may not be given in the case of casual/ nonrepetitive advertisements.

7.4 Malpractice through Agency Network: In spite of the fact that small newspapers/ magazines are not usually profitable, more entrepreneurs enter the field. One reason could be that these units may be used to introduce unaccounted money in the books under the pretext of agency deposits without any tax consequences. Another malpractice that is often resorted through agency network is of allowing rebates/ discounts for unsold copies and incidental expenses. Many of these rebates/ discounts may turn out to be bogus and done only with intent to reduce the sales revenue. In all such cases it is necessary to obtain copies of the accounts in the books of the agents and also obtain confirmation from them with particular reference to the credit notes issued in their favour by the magazines.

7.5 News Gathering Expenses: The remuneration to senior and experienced editorial personnel may bear examination as they may be insisting on payments without any tax liability. The magazines usually disguise these payments as news gathering expenses. There could be violations of the TDS requirements envisaged in Section 194J in respect of payments to freelance contributors / reporters and honorarium paid to authors.

7.6 Paid News: According to a Press Council's report, paid news is "any news or analysis appearing in any media (print & electronic) for a price in cash or kind as consideration". It is a complex phenomenon that had acquired different forms over the last decades, ranging from accepting gifts on occasions, foreign and domestic junkets, various monetary and nonmonetary benefits, besides direct payment of money. Private treaties signed between media companies and corporate entities could also be part of the phenomenon. The whole exercise may involve use of unaccounted money.

7.7 The advertisement incomes especially in respect of the Classifieds casuals and regular, matrimonials etc. merit verification. The Assessing Officer may call for column rates for each class of advertisements and the total columns used for advertising for a particular day and the assessing officer can examine whether the advertisement income is proportionate to the admitted income or not.

7.8 Other potential lines of enquiry can be the News gathering expenses, Editorial expenses (production costs for editorial content), Advertising expenses (cost of soliciting and producing advertiser's copy), Mechanical expenses (production costs for composing, and press rooms), Circulation expenses (cost of delivering and billing newspapers sales and maintenance of circulation volume), Commission paid and/ or rebate allowed etc.

8. RATIO ANALYSIS

8.1 Like in other cases, in cases of printers and publishers of newspapers also investigations of accounts can be done fruitfully by making a ratio analysis of major heads of income and expenditure for a particular assessee for a period of, say, two or three years. This analysis would indicate the area of specific investigation required and also the business trend.

8.2 In the cases of printers and publishers of newspapers it is not possible to give a specific ratio on any particular aspect as each of them may have varying degree of technological support for their businesses. However, the major areas of ratio analysis can be as under:

a. **Ratio of Advertisement Income** *viz.* classified casuals and regular, matrimonial etc. The Assessing Officer may call for column rates for each class of advertisements and the total columns used for advertising for a particular day and the same can be multiplied by the total number of the days and see whether the advertisement income is in proportion

to the admitted income. The AOs can compare the advertisement rates of other comparable market players to detect possible suppression.

b. Consumption of paper issuewise (i.e. Edition or magazinewise) and issuewise per centage of wastage of consumption of paper.

c. News gathering expenses.

d. Editorial expenses (production costs for editorial content).

e. Advertising expenses (cost of soliciting and producing advertiser's copy).

f. Mechanical expenses (production costs for composing, and press rooms).

g. Circulation expenses (cost of delivering and billing newspapers sales and maintenance of circulation volume).

h. Commission paid and or rebate allowed/ claimed.

i. Employee expenses.

It would be fruitful to analyze the major expenditure claims under the head cash payments and cheque payments also. This analysis would throw up enough clues to choose the line of investigation.

CHAPTER

6

Printing and Publishing Industry

A. PRINTING

1. INTRODUCTION

1.1 The Indian Print Industry has undergone a revolutionary change in the last 15 years. In 1990, India initiated a process of reforms aimed at shedding protectionism and embracing liberalisation of the economy. Privatisation was initiated with the aim of integrating the Indian economy with the world economy. This change opened the doors for the Indian Print Industry to modernise, by investing in the latest technology and machinery. The average compound annual growth rate of the industry has been higher than 12% over the last 15 years. Prior to 1990, most printers found it easy to invest in East German and Czechoslovakian machines. Post 1990, the trend has been to acquire the latest and the best equipment & machines. The progressive printers of today are equipped with the latest computer controlled printing machines and flow lines for binding, while state of the art digital technologies are being used in prepress. Leading print companies have optimised the use of information technology in each and every area of their business. These printers are today equipped at par with the best print production facilities in the world.

1.2 Today, India is one of the major print producer & manufacture of printed paper products for the world markets. The quality standards have improved dramatically and immense production capacities have been created. Some printers have won recognition by winning prizes at international competition for excellence in printing. Indian books, journals and printing jobs, etc. are being exported to over 120 countries of the world, both developed and developing.

1.3 The Indian Printing Industry, comprises more than 250,000 printing companies. India is the country with one of the largest number of printing presses in the world. India with approx. 25 lakh employees is second only to China (30.25 lakh) so far as the number of employees in printing sector is concerned. Employees and number of printing companies are decreasing by 6 per cent world over, including China, whereas in India it is progressing at 5.2 per cent annually.

The industry has grown leaps and bounds due to the latest technology and machinery, quality standards and production capacities.

1.4 The Printing Activity are Broadly Classified into: (a) prepress (b) press and (c) finishing. The 'prepress' stage of the activities consists of typesetting; scanning; film processing; and platemaking. The 'press' stage is the actual printing work. The third stage is the finishing stage from which the final product emerges after stitching and binding.

2. PREPRESS PROCESSES

2.1 Typesetting is the first stage. The process has graduated from mechanical typesetting of yore to photo typesetting and now to desktop publishing (DTP). In photo typesetting, photographic method is used to transfer the type image into a medium like film or bromide paper. Photo typesetting is the cheaper process for high volume books with a lot of graphics and colour printing. The technology has advanced from the first generation when magnetic tapes were used for images to the fifth generation where laser is used for transfer of images.

2.2 DTP involves the use of microcomputers to produce publications which previously required traditional publishing technology. Now, typesetting is done mostly on DTP systems. The process derives its name from the fact that, with the basic hardware, one can produce a publication on the table, without ever needing to go near a typesetting factory or a printer.

2.3 Due to low price of its equipment, DTP enables production of books which would have been too costly to produce using the old technology. DTP is used in all aspects of production in the publishing industry, i.e. writing, designing, graphics and typography. DTP is versatile. It allows an individual or an organisation to print copies of its own publication on the desk top or to produce 'cameraready art work' as the basis for traditional printing. Earlier, production of such work required a team of people to put it together. The time taken was large. There was more likelihood of errors. With the DTP technology, a page of a book can now be produced in a matter of minutes. There is no need for a compositor. The originator can lay out the pages of his publication the way he wants them to appear. He can have a greater degree of control over the final product. He can quickly and cheaply test different designs to produce a variety of trial pages. DTP software facilitates mixing of text and graphics and mixing of English with Indian language(s). The software can easily be integrated into a network solution which helps to share information, files and printers with other terminals/ nodes in the network. Software with Indian languages is available locally. Shortrun books and manuals, magazines and newsletters for a small circulation are now feasible. DTP enables magazine editors to test their ideas out, producing near typeset quality pages. This enables greater creativity and a wider range of design being put into practice. DTP products excel in their appeal and readability. DTP is paving way for a major revolution in business communications. Computer electronics and laser have given simple solutions and better options to the customer at the prepress stage.

2.4 The prepress processes use both local and imported machinery. For scanning, while table top scanners are locally made, drum scanners for high quality reproduction have to be imported. For film processing also the equipment used vertical cameras and negative processors are locally available. Similarly, plate exposing and developing equipments are also available locally.

2.5 In modern printing processing houses play a major role. The equipment needed for high

quality printing is expensive. A single printing press cannot afford to have all of them. Besides, it does not need to own them also. The capacity of the equipment is so large that a fraction of it would be sufficient for a single printer. Here, processing houses play their role and fill a felt need. They have the expensive equipment needed for modern printing. The printers go to them for meeting their processing needs. The processing houses supply banners, inputs for hoarding, slides and CDs for presentation, with the use of digital printing.

2.6 The arrangement between the processing house and the printer is generally based on the standard terms. The processing house charges at rates per sq. cm. for processing. The unit for charging quantity is the number of proofs. The terms which prevail now are likely to change with the arrival of the dry proof system. More number of proofs at a nominal cost or even for free will be possible with that system. In case of other technologies the cost per extra proof may go up. Processing houses presently charge sales tax at 8 per cent in Tamilnadu on their supplied inputs (which are inputs for their customers). From the input supplied, printers make their own imagecarriers (e.g. offset plates) or get them made again by another trade house like a plate making unit.

2.7 In recent years, prepress software has been developed which is designed to find as many efficiencies in prepress workflow as possible. These tools are accessed online, and allow different workers to work on one project at the same time, often from different locations. Key functionality automates common steps to reduce errors, reinforce quality standards and speed up production. Examples include automatically refolioing pages, digital dummies for soft proofs, live linking with Adobe in Design and preflight checking. These tools revolve around a Flat plan and are used in all sorts of prepress including book, magazine and catalog production.

3. THE PRESS STAGE

The press stage of the work is the actual printing activity. Printing machinery of various sizes are manufactured locally or imported either as rebuilt (secondhand) or as new on actual user license.

4. THE FINISHING STAGE

Finishing stage involves processes like computerized cutting, perforating, side and centrestitching, laminating, punching, creasing, folding, Sectionsewing and perfect binding. For all these processes machinery is available locally or imported.

5. ORDER PROCUREMENT

5.1 Orders are initially received through personal contact. By continuous and personalized servicing, orders keep coming regularly from clients. Walkin jobs are only of a small nature, like visiting cards, invitation cards, etc. Orders may also be received by successfully quoting for tenders.

5.2 In the case of bulk printing like calendars, picture posters and greeting cards, 'agents' are engaged. They go far and wide and procure orders. Calendar work is in a class by itself. Thousands of copies of particular pictures are printed in bulk. Then in smaller lots details of particular enterprises are overprinted depending on orders. In this process both the printer and the particular enterprise are benefited. The enterprise is able to get the calendars at a much less cost. There are also 'jobbers' who do not have any printing facilities, but who canvass jobs using their personal contacts. Thus, there are four ways in which a printer gets orders, i.e. directly, or through regular clients by way of purchase orders, or through agents, or through jobbers.

6. ORDER PROCESSING

6.1 Procurement of Raw Materials: Frequently used paper and board are usually kept in stock. As and when large requirements arise, paper is procured locally from distributors/ dealers of manufacturers. When large quantities of paper are needed, say, for printing Balance Sheets or books, order is placed directly with the paper mill through the local distributor. The same pattern is followed for purchase of inks, plates, chemicals and binding materials.

6.2 Printing and Supplying: The job docket specifies the date of delivery, based on which planning takes place. The prepress activities are completed and the job scheduled for printing, finishing and supplying. Typesetting may be done internally or externally; but scanning and film processing are usually done externally. This is because the equipments needed are expensive and owning them is not cost effective for a single unit. Platemaking is usually done internally and so also binding and finishing, unless some special requirement like lamination or goldfoil stamp is required.

7. PAYMENTS

Printing is almost always done on credit. Credit runs through the system. Only for very small onetime jobs, customers pay immediately. The credit period varies from 30 days to, sometimes, even 120 days. Raw materials are bought on credit. Typesetting, scanning, film processing and even binding and finishing services are bought on credit. Units having working capital limits with banks are able to pay faster, but on the whole, the market credit for all services range from 1590 days. Payments are usually made and received in cheques, except for very small onetime jobs.

8. ACCOUNTING

8.1 A printer has to maintain accounts in order to ascertain his cost and billing and to get adequate control of operations. Besides the usual financial books of original entry, he normally maintains the following books:

a. Order book

b. Stock account

c. Daily docket cards

d. Daily production register

e. Job card sheets

8.2 The order book contains a chronological record of printing jobs undertaken. The stock account contains detailed accounts of items consumed during the printing process like ink, paper, binding and other material. The daily docket cards are meant for keeping the record of work done by each individual worker. The daily production register is compiled from daily docket cards. It is maintained job wise. The job sheets contain summary of daily production and details of individual operations. The purpose is to exercise proper control over employees and to have an idea of profit or loss in the course of working. All these books are maintained in electronic form in computer these days in majority of printing houses.

9. OUTLOOK

9.1 A long running battle was going on in some states between the Sale tax departments and the printers, on the issue whether printing involves sale of goods and thus attracts sales tax liability. The contention of the printers was that it is merely execution of a work contract. They deny any liability to sales tax. In Tamilnadu, the Sales Tax Department is of the view that printed material produced to individual specifications

of customers amounts to goods sold. It levies 8 per cent sales tax. This levy is said to have introduced considerable amount of uncertainty and confusion and flight of business from such states to neighbouring states where such levy is not imposed. However, after the adoption of GST, Printing is no more a works contract under current GST Law. The reason why it is no more a works contract in GST is because under current GST Works Contract only includes Immovable Property unlike in VAT & Service tax before, where Works Contract Included both Movable and Immovable Property. So whenever there is confusion in GST as regard to whether printing leads to goods or services, one has to examine the dominant intention. For Example, when one takes content from publisher and printed the books then he is rendering printing services but the publisher is a seller and he will be deemed as selling goods under Chapter 4901 and HSN Code rate of GST will apply.

9.2 The outlook for the business is neutral. Spiraling paper prices is a major factor affecting the business. It is claimed that the printers are not able to give firm quotations for job works and are losing on the jobs and contracts already accepted. The solution offered includes import of the maplitho and cream wove varieties of paper and reduction in customs duty on all varieties of paper. Another solution given is removal of the ambiguity surrounding the industry to state clearly whether it is, or is not, one of execution of works contract.

10. TAX INVESTIGATION

10.1 Like in any other business, in this line also, the orders received may be understated, receipts suppressed and/ or expenses inflated. There may be cases of collusion between the person placing the order usually a publisher and the printer. These aspects may be checked by reference to the original records like order book and job cards and by cross-verification. The consumption of ink, paper and stores may indicate the number and extent of the orders executed. The inflation of other expenses can also be verified by looking into the details in the original records.

10.2 In printing, as already indicated, processing houses play a major role. A printer gets many things done from a processing house. It is worthwhile to check whether the service charges paid are reasonable. Here also crossverification may yield results.

10.3 In certain cases the printer has been constantly indulging in unaccounted purchases of paper, ink and other printing material. Mostly, the printer who is also doing job works in printing and binding, will keep those accounts outside the books. Therefore, Assessing Officer should cross verify with the major client's books for verifying possible suppression in accounting.

10.4 The claim of investment allowance and depreciation, if any, should be thoroughly verified by the Assessing Officer as the industry involves purchase of high cost machineries.

10.5 The import of machinery, if any, may be verified with the customs department to ascertain the actual cost of the machinery.

B. PUBLISHING

11. INTRODUCTION

11.1 Book publishing in India refers to the process of book creation within India, a growing field in recent years, which makes the country the sixthlargest book publishing nation in the world. While there is optimism about the growth of Indian publishing (especially in urban India), the sector is also afflicted by a lack of accurate figures about books published, knowledge shared and revenues earned. It is further divided between the local and multinational players, the English language and the local languages publishers.

11.2 The business of publishing English books in India can be divided into three categories:

a. Publishing of books by Indian authors

b. Publishing in India of books written by foreign authors (for Indian consumption) and

c. Publishing in the export processing zones in India of books written by foreign authors for export.

11.3 A publisher may have a printing press of his own and may be printing his books himself. But this is not common. Most publishers do not have any printing press of their own. They have arrangements with printers and get the books printed in those presses.

11.4 The main raw material in this line is paper. There are three major types of paper Snow white paper; Ordinary white paper; and News print. The choice of paper depends on the type of publication intended. Though it is not common, recycled newsprint is also sometimes used for printing cheap, inexpensive books.

12. THE PROCESS OF PUBLISHING

12.1 The first step in publishing activity is the receipt of manuscript from the author. The publisher has an editorial board which goes through the manuscript to decide its merit and marketability. The fact that the script had already been serialized in magazines or newspapers makes the decision easy. In the alternative, the publisher may engage a reviewer on payment.

12.2 The review by the reviewer or the editorial board is an important process. The purpose of the review is chiefly to assess the quality of the work in relation to the readers for whom it is intended. The other purposes include ensuring that the script is free from major mistakes and obtaining suggestions for improving the script. If the reviewer is not paid well, the review may be indifferent and superficial. It may not achieve the intended purposes.

12.3 After the editorial board/ reviewer decides in favour of publishing the material, the publisher negotiates the terms of the publication with the author including the royalty. The royalty may be fixed or may be variable as a percentage of the sales. In language publishing normally 10 to 15 per cent of the proceeds is the royalty given to the author. Where the matter to be published is more than a hundred years old no royalty needs to be paid. Certain works or works of certain authors may be nationalised by the government. In that event the royalty is paid by the government to the owner(s). Any publisher could now publish it/ them without any royalty obligation.

12.4 The copyright usually rests with the author. He makes over the right to publish a particular edition to the publisher and gets royalty in return. There may be cases where the author may part with the ownership itself of the work for a lump sum payment from the publisher. This enables the publisher to bring out as many editions as he might choose without having to make any further payment to the author.

12.5 The publisher fixes the price of the book taking into consideration various factors. The demand for the title, the popularity of the author, the quality of the paper used, the targeted audience etc. are major factors. Raw material cost, royalty, printing expenses, marketing expenses and sales prospects are also reckoned. Economy of scale operates in pricing the titles. If the demand is more the price can be fixed low. Reprints generally cost less. The difference between the paperback edition and the deluxe edition is too well known to be discussed at any length. The margin of profit in this line, especially in language publishing, is claimed to be low as low as 10 per cent.

13. MARKETING

13.1 Publishers having their own sales outlets are not many. The marketing is done largely through retail booksellers. The publisher allows trade discounts of upto 30 per cent to retailers.

The retailers get copies from the publisher on credit and settle accounts when sales are effected. They may retain unsold copies for sometime anticipating sales. If the expected sales do not materialize such copies are returned to the publisher. The returned copies pose a major problem as they are bound to be soiled or damaged. Their storage and their selling are both difficult.

13.2 Pre-publication schemes are prevalent in this line. Usually, an advertisement is made in newspapers and magazines about the proposed publication and the terms of the pre-publication concession. The prospective buyer is expected to register his name by a specified date and pay the reduced price in advance either in one lump or in installments. This enables the publisher to get an idea about the demand for the title. It also gets him the sale proceeds (though discounted) in advance. This reduces the interest burden and also the demand on storage.

13.3 Book exhibitions are occasions when sizable sales are effected. The discounts offered at the exhibitions make bookbuying an attractive proposition. The publisher himself may participate in the exhibition or ask the retailers to take part with his (the publisher's) titles. The concept of book exhibition as a major social event is catching up in cities and big towns. This augurs well for the publishing industry.

14. TEXTBOOK PUBLISHING

14.1 Among the medium and small publishers, the people who are successful are those who publish syllabusbased textbooks for target student population. Their success is attributable to the fact that the price of the book is low; its language is simple; it strictly covers the syllabus with no additional material; and it contains easily identifiable answers for the questions usually asked in the examinations.

14.2 Photocopying has come to affect the business greatly. The prohibitive prices of standard textbooks have driven the students to this measure. Whole books or portions thereof are copied at a fraction of the cost. This obviates the need for buying the book.

15. OUTLOOK

15.1 The publishing industry is passing through difficult times. Even though literacy is on increase, readership is shrinking. TV and Internet have affected reading habits of the public. Light magazine reading has almost replaced serious book reading. Glossy magazines with colour photos pose danger to books. Cost of publishing is high. Advertisement on TV is beyond the dreams of even the most affluent publisher. Storage is a major problem. The returned unsold books can be sold only at a great discount or as waste. The publishers find it difficult to get loans from banks. Printed titles are not usually accepted by banks as security. They accept unprinted paper, not the printed book. Often, there are 'bruising battles' among authors, publishers and booksellers over the revenue from slowgrowing book sales.

15.2 The publisher has to get almost all items of work like composing, printing and binding done on contract basis from outside. He has to allow margins to the contractor/ printer. He has to recover this from the sale proceeds of the book which may take months to materialise. The above problems besetting the publishing industry cry for early solution.

16. E-PUBLISHING

16.1 India has witnessed growth in the electronic publishing sector since the country's population is highly evolving to utilise smart gadgets especially Apple Iphones, Amazon kindle and many more. The books of many native Indian author's which were sold in physical formats; many publishers have started utilizing the electronic mode to sell digital books of the same sort. The future of epublishing in India will have a transition from hardcopies to soft touch screens. Though publishing ebooks

and digital content is in its infancy in India, the sector will boom in the near future. As per recent report by the Press Trust of India (2015), 70% of publishers have already embraced digitization of their books.

16.2 In addition to the digitization of content, epublishing includes other typesetting activities such as pagination, copyediting, proofreading, graphics and design, and so on. These activities were outsourced by international publishers to companies in India. The digital books have one major risk. They will be entirely at the mercy of hacks and pirates since they will be circulating over the Internet. This paves way for technology companies to come in as middlemen with software and services to store and transmit digital books, offering protection from copying. This is a role similar to that of distributors of traditional books.

17. TAX INVESTIGATIONS

17.1 The persons so minded resort to concealment of income by inflating expenses, underreporting the receipts or suppressing a part of the business altogether. They may even resort to all the three methods. The expenses to be especially checked are the cost of inputs, printing charges and royalty to the authors. Claims of discounts should be checked for possible inflation. Understating the sales or stock is possible. The agreed terms for sales of book between the publisher and the booksellers should be studied to see whether the accounts are in tune with such terms. In suspicious cases crossverification with booksellers should be done. Bookwise quantitative tally may help in locating stock discrepancies.

17.2 Concealment of income has been noticed in certain cases of text book publishers. The large volume of business allows scope for large scale manipulations. During the course of search of one such publisher revealed that the assessee was indulging in inflation of purchases through bills not supported by actual delivery of goods. This was in purchase of paper used for printing text books. The assessee and the paper supplier colluded in the bogus transaction. The action proved that the assessee consciously inflated purchases through bogus bills. The modus operandi was that bills not supported by actual supply of materials were raised by the supplier. The assessee issued cheques for the billed amounts. Thereafter the supplier withdrew cash and paid the assessee after deducting his commission for the accommodation.

17.3 Major booksellers import foreign books and sell them at the printed price. In foreign countries, storage and shelf space are expensive. Unsold copies of books are discarded after some time on the shelf. When a later edition comes out the copies of an earlier edition of a book are usually sold away by the publisher as waste paper. An Indian importer sometimes finds in this a good opportunity to make money. He buys the discarded copies at the scrap rate, imports them into India and sells them at the printed price as if they are new. The import is often overinvoiced to be in accord with the printed price. The inflated purchase price is either retained abroad and spent there or brought into India through other means. Even some reputed booksellers are engaged in this activity.

17.4 Making himself familiar with the trade practices will enable an AO to embark on meaningful investigations. Information is power, not only in the technological sense but also in the conventional sense.

18. CASE STUDY

18.1 In a case of search u/s 132, the officers found that the assessee, a major publisher, was resorting to both unaccounted purchases of printing material and unaccounted sales of books. It was also doing job works of printing and

binding outside the accounts. Nearly 40 per cent of its turnover went unrecorded in the accounts. The money received against the unaccounted sales in the form of cash, cheques and drafts was deposited in a bank account not disclosed to the Department. The unaccounted sales benefited the assessee in two ways it could save on taxes. It could also avoid royalty payment to the authors referable to the unaccounted sales. Royalty was at ten per cent of the total sales of the books. The royalty was paid only on the accounted sales.

18.2 The assessee's modus operandi was as follows: It would receive orders from the party interested in cash purchases without proper bills. It would supply books on the basis of invoices made, as per the rate prevalent on that date. The invoices would be sent along with the books to the buyers. They would not be posted in the books. The price would be received in cash which would go unrecorded in the books. The amount would be deposited in the undisclosed bank account. Such unaccounted receipts would be utilised for making unaccounted purchases chiefly and in a smaller extent for withdrawals relating to the personal and household expenses of the partners.

18.3 The assessee was maintaining duplicate sets of books including duplicate sets of sale bills. It was making duplicate sets of entries in the computer one set pertaining to regular transactions and the other to the unaccounted ones. The unaccounted set was shielded by a password. It was not accessible through normal commands of the accounting software. Only shortcut keys assigned separately to the duplicate commands could open the unaccounted transactions. The assessee was maintaining the following books for the purpose of controlling the unaccounted transactions:

a. **Cutting Register:** The register was divided into different columns like date, invoice no., name of party, place, amount and remarks. Whenever any payment for unaccounted sales was received by the assessee, the corresponding bill number and the party number was struck through. The remaining portion showed the outstandings from the buyers.

b. **Party Ledger:** This contained the names of the parties with the debit and credit entries. The debit entries reflected the unaccounted sales and the credit entries, the payments received against them.

c. **Invoices with Same Numbers:** Invoices with same numbers had been used on different dates. The numbers printed on the invoices were not serially marked. Different sets of unaccounted bills were prepared with the same invoice numbers. This showed that the assessee indulged in the practice of unaccounted sales with invoices dubiously indexed.

18.4 The assessee had made unaccounted expenditure. It pleaded ignorance about the whereabouts of the recipients. The plea was not accepted. The reasoning was that the assessee had been enjoying the services of these parties for printing and binding and had been making sizable payments to them. The transactions involved transportation of stock of books to and fro their premises. Delivery challans bearing their addresses were a mandatory requirement. Hence the AO was requested to locate the addresses and assessment particulars of these parties and start proceedings under Section 153C.

19. IMPORTED BOOKS

19.1 This is about booksellers, not publishers: Quite a few of them import foreign books and sell them at the printed price. In foreign countries, storage and shelf space are expensive. Unsold copies of books are discarded after some time on the shelf. When a later edition comes out the copies of an earlier edition of a book are usually sold away by the publisher as waste paper.

An Indian importer sometimes finds in this a good opportunity to make money. He buys the discarded copies at the scrap rate, imports them into India and sells them at the printed price as if they are new. The import is often overinvoiced to be in accord with the printed price. The inflated purchase price is either retained abroad and spent there or brought into India through other means. Even some of the reputed booksellers are said to be engaged in this kind of activity.

19.2 The import of the books may be cross verified with the customs authorities to detect possible discrepancies.

20. CONCLUSION

Making himself familiar with the trade practices will enable the AO to embark on meaningful investigations. Information is power, not only in the technological sense but also in the conventional sense.

CHAPTER

7

Motion Picture Industry

1. The Indian Motion Picture Industry, or popularly known as the "Film Industry" is the world's largest in terms of tickets sold and number of films produced (nearly 1000 feature films and 1500 short films every year). The Indian film industry grossed revenue of Rs. 17,300 crore in 2017 and it has grown at a CAGR (Compound Annual Growth Rate) of over 10% in the last couple of years. It is expected to grow at 11.5% year-on-year, reaching total gross realisation of Rs 23,800 crore by 2020. The main income of the Film Industry comes from domestic theatres, followed by overseas theatres and broadcast rights.

The Hindi film industry, contributes 43% of the revenue, while the regional films contribute the remaining 57%. In terms of number of films produced Telugu and Tamil movies now outnumbered Hindi movies.

1.1 In 2001, cinema was given industry status. Thereafter, the film industry in India witnessed a major change in terms of financing and also through the entry of global giants—from Walt Disney to 20th Century Fox—either by itself or via partnership. Post 2001, the budgets of films have increased, as have the frequency of their worldwide releases and the scale of their grosses.

Revenues	2016	2017	2018E	2020E
Domestic Theatres	85.6	96.3	103.0	118.0
Overseas Theatres	8.5	25.0	25.0	28.0
Broadcast rights	16.0	19.0	20.0	22.0
Digital/ OTT rights	6.0	8.5	10.0	14.5
Incinema advertising	5.9	6.4	7.5	9.0
Home Video	0.4	0.3	0.2	0.2
Total	122.4	155.5	165.7	191.7

(Gross of taxes, INR billion)

(Source: EYFICCI Media report, 2018)

2. FILM STUDIOS

A film studio (also known as movie studio or simply studio) is a major entertainment company or motion picture company that has its own privately owned studio facility or facilities that are used to make films, which is handled by the production company. The majority of firms in the entertainment industry have never owned their own studios, but have rented space from other companies. There are also independently owned studio facilities, which have never produced a motion picture of their own because they are not entertainment companies or motion picture companies but they are companies who sell only studio space. With the growing diversification of studios into such fields as video games, television, theme parks, home video and publishing, they have become very big companies. The studios have also transformed into financing and distribution entities for the films made by many production companies. Many studios also offer tours of their backlots like *Ramoji Rao Film City* in Hyderabad and *Goregaon Film City* in Mumbai from which also they earn substantial revenue.

3. SEGMENTS OF MOTION PICTURE INDUSTRY

There are three distinguished segments of Motion Picture Industry:

a. Production

b. Distribution

c. Exhibition

The Segments

PRODUCTION → DISTRIBUTION → EXHIBITION

Stages of Production

PRE-SHOOTING	SHOOTING	POST-SHOOTING
Idea & Concept	Planning	Editing
Script & Its breakdown	Matching dates of all the cast & crew	Background music
Crew identification & casting	Erecting sets	Dubbing
Identification of location	Hiring locations	Negative cutting
Budgeting & scheduling	Arranging all the equipment	Other post production
Market analysis	Shooting	Printing
Funding	Music recording	Publicity
Contract with Cast & Crew		Distribution & release
Insurance		

Distribution

THEATRICAL

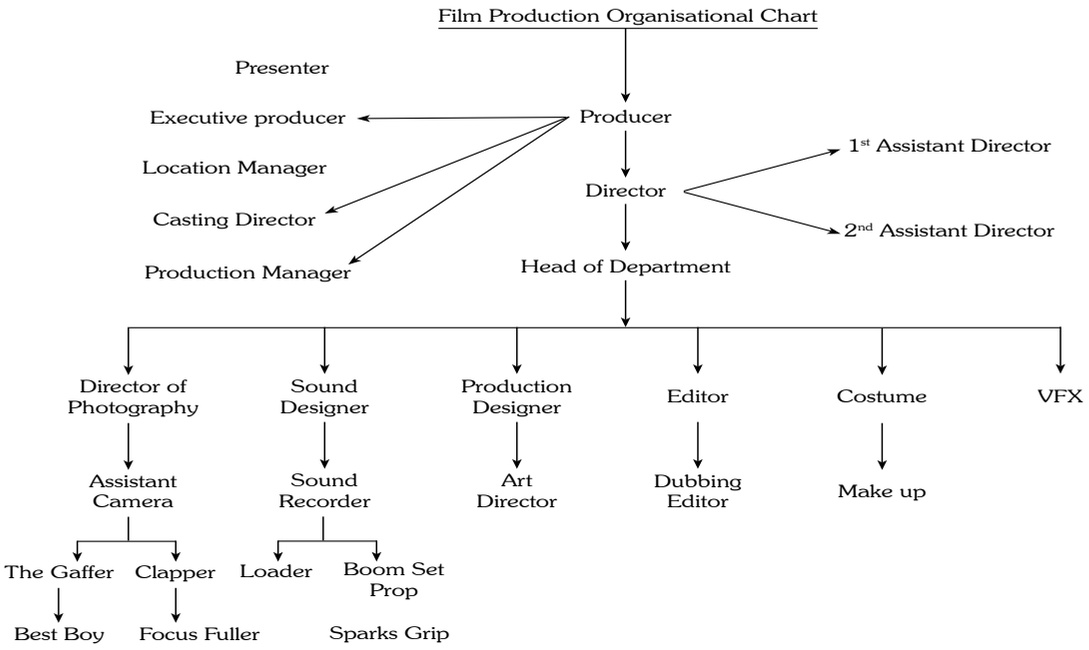
Domestic (Divided In Six Territories)	Overseas
Bombay Presidency	Initially, there was a Single distributor for Different Countries
Delhi-Utter Pradesh	
Eastern Circuits	
MP & Rajasthan	Now movies are being sold to multiple distributors for different nations
East Punjab	
South & Nizam	

NON-THEATRICAL

Domestic	Overseas
Satellite	Satellite
Music	Music
Video, Cable, DVD, VCD	Video, Cable, DVD, VCD
Internet	Internet
Others	Others

4. FILM PRODUCTION

Numerous persons are associated with the process of film Production. A diagrammatical presentation of the persons involved in this process is given below:



A. Some of the important persons associated in this process are described as under:

4.1 Presenter: In films, a presenter is a usually a wellknown executive producer credited with introducing a film or filmmaker to a larger audience.This person is the source of funding for the movie and the ultimate advocate for the investors and the intended audience.

4.2 Producer: The Producer is essentially the group leader and is responsible for managing/ coordinating the production from start to finish. The producer develops the project from the initial idea, makes sure the script is finalized, arranges the financing and manages the production team that makes the film.

4.3 Director: The director is primarily responsible for overseeing the shooting and assembly of a film. A director works at the centre of film production, but is inextricably linked with dozens of other people who get the job done together.

4.4 Production Manager: They are the manager for the whole location, including the camera shoot. They coordinate between departments and between the shoot and the producer or studio. They hold the purse strings (although are accountable to higher powers), so are the ultimate decider on fixing problems that can't be resolved immediately on set.

4.5 Production Designer: The production designer translates the script into visual form through storyboardswhich is a series of sketches on panels that shows the visual progression of the story from one scene to the next. It ensures the visual continuity of the film and serves as the director's visual guide.

4.6 Actors: Responsible for portraying the characters in a film, the actors work closely with the director and cinematographer.They are the highest paid amongst all the persons associated with a moviemaking.

4.7 Writer: Every movie has to be first conceptualized and then written down in the

story format. A writer writes the entire story sometimes even with the dialogues. A separate dialogues writer is also entrusted with the job of dialogues writing.

4.8 Screenwriter: While the dialogue in a film may seem natural to the viewer, a writer carefully crafts it; however, the screenwriter does far more than provide dialogue for the actors. He or she also shapes the sequence of events in a film to ensure that one scene transitions to the next so that the story will unfold logically and in an interesting way.

B. Technical Members of the Movie Production

4.9 Director: The art director is responsible for the film's settings: the buildings, landscapes and interiors that provide the physical context for the characters. This person is responsible for acquiring props, decorating sets and making the setting realistic.

4.10 Costume Designer: Costumes convey a great deal about the film's time period and the characters.

4.11 Cinematographer: The director of photography, or DOP, is responsible for capturing the script on film or video. The DOP must pay attention to lighting and the camera's technical capabilities.

4.12 Editor: Shortly after shooting begins, the editor begins to organize the footage and arranges individual shots into one continuous sequence. Even in a single scene, dozens of different shots have to be assembled from hundreds of feet of film.

4.13 The production of a movie is carried out in 3 Stages: 1) Pre-Production, 2) Production and 3) Post-Production.

a. At the Pre-Production stage, the Producer finds a script or hires someone to write one based on a book, article or an idea he may have. When the script is ready; the budget is prepared and the Producer looks for financiers to invest in his film. Also, at this point, the Actors, Director and Production Manager and other staff are hired.

b. During the Production stage, the Director instructs the Actors and confers with the Cinematographer and other technicians in order to get the best possible shots. Once the entire script has been shot, the film moves to the Post-Production stage.

c. In Post-Production, the actors finish dubbing (if required) plus Special Effects, Background Music and Sound Effects are added to the film. Once Post-Production is complete the Producer sells the film to a Distributor for a profit.

5. POST-PRODUCTION (FILM PROCESSING)

5.1 Post-production or film processing is part of the process of filmmaking, video production and photography. Post-production includes all stages of production occurring after shooting or recording individual program segments. Post-Production is many different processes grouped under one name, which include:

a. Video editing the picture of a television program using an edit decision list (EDL).

b. Writing, (re)recording, and editing the soundtrack.

c. Adding visual special effects mainly computergenerated imagery (CGI) and digital copy from which release prints will be made (although this may be made obsolete by digitalcinema technologies).

d. Sound design, sound effects, ADR, foley, and music, culminating in a Process known as sound rerecording or mixing with professional audio equipment.

e. Transfer of color motion picture film to video or DPX with a telecine and color grading (correction) in a color suite.

5.2 There are many companies mainly in the cities of Chennai, Mumbai, Hyderabad and Bangalore which are involved in the above business of film processing and Post-Production processes. Their main source of income is Virtual Print Fee which they collect from the production houses and also may have income under other heads like lease rental income on digital cinemas, maintenance service fee, technical service income and advertisement revenue. The main heads under which the expenses incurred are delivery and distribution charges, content processing charges, installation charges, virtual print fee sharing charges, rent on equipments and employee related expenses. The AO has to be vigilant as there may be a chance that these expenses maybe inflated or may be paid to other concerns without TDS as these are deductible u/s 194J of the IT Act.

5.3 A Producer receives a minimum guarantee fee from a distributor in return for film rights in a territory within the country. If the movie does well and the distributor recovers his money, any additional inflows get divided between the two. Additional revenue comes from overseas rights, satellite rights, home video market and, music (wireless and Internet downloads). If the producer owns the intellectual property rights and has not sold it off in perpetuity (generally, music rights are sold off in perpetuity, satellite for 10 years and digital rights, *viz.* Hotstar/Netflix/ Amazon Prime are given for five years), he could make money selling his library to a TV channel in the long term.The Producer or say, executive producer gets the initial finances from banks or others such as a high net worth individuals or companies to put in money as equity, or, raise money upfront from distributors, or through selling some of the rights early to finance the film.

6. FILM DISTRIBUTION

The second important segment is that of distribution of the movie so produced. A person who distributes the film through the theatres is called film distributor. The distributor buys the "distribution rights" from the producer, mostly in the very beginning itself or sometimes after previewing the final cut. However, the preacquiring of film distribution right is based on the cast, crew, director, story and the producer's past success record. Also, nowadays it is fairly common that the producer himself, distributes the films without a third party (or) an independent film producer so as to avoid the distributor expenses. On the basis of entertainment tax and geography, Film Distribution Association of India divided the state provinces into 11 circuits for distributing the films. Sometimes, the distributors directly distribute films to all these circuits, while other times the main distributor rents (or) sell the films to a local film distributor.

6.1 Digital Film Distribution: Many companies are now doing the business of digital cinema distribution network and incinema advertising platform. They operate mainly satellitebased digital cinema distribution network using their specific technical platforms. Now almost all the cinemas are totally digitized and their digitization and delivery model has been a key driver of extensive digitization of Indian cinemas and has enabled widespread, same day release of movies across India. For instance a leading Indian Digital film distributor along with its subsidiaries and associates, operates 5,970 screens worldwide, including 5,289 screens across India and 681 screens across the Middle East, Mexico and the USA. These companies basically add value to all stakeholders in the movie value chain, spanning movie producers, distributors, exhibitors and the cinemagoing audience. They provide value to movie producers

and distributors by reducing distribution costs, providing reach to a wide network, providing a faster method of delivery of content and reducing piracy through encryption and other security measures. They provide value to movie exhibitors throughout India by providing access to first day release of movies on our digital platform. Audience benefits from faster access to new movie releases and a consistent high quality viewing experience.

6.2 Mostly these companies also have incinema advertising platform which enables advertisers to reach a targeted, captive audience with high flexibility and control over the advertising process. Their incinema advertising platform also allows small exhibitors who otherwise are not able to effectively monetise their advertising inventory due to their limited scale and reach to receive a greater share of advertisement revenue than they are able to using traditional advertising methods.

7. FILM EXHIBITION

The film exhibition is the last segment of the motion picture industry wherein the movie is displayed to the audience and actual income accrues in the producerdistributorexhibitor chain. An Exhibitor owns the theatre or sources a theatre. The Distributor makes arrangements with Exhibitors to exhibit a film in as many of their screens as possible and the Exhibitors earn a share of net collections (revenue after educating entertainment tax from the gross collections) as agreed upon. Generally, in the first week, the Exhibitors and Distributors divide the net collections equally. In the second week the Exhibitors share goes up to 57.50% and in the third week, the Exhibitors get 62.5% and Distributors earn 37.5% share. Beyond that time, the Exhibitors earn 70% and Distributors share drops to 30% of the net collections.

8. MEDIA SERVICES PROVIDERS: (NETFLIX/ AMAZON PRIME/ ZEE5/ HOTSTAR/ SONY PLATFORMS)

8.1 These concerns' primary business are its subscriptionbased streaming OverThe–Top (OTT) media services which offers online streaming of a library of films and television programs, including those produced inhouse. The growth of these service providers in India in recent years is tremendous and their revenues are growing in an exponential manner. They have greatly expanded the production and distribution of both film and television series and offer a variety of original content through their online library. These service providers like Netflix and Amazon Prime almost operate all over the world except few countries. Their efforts to produce new content, secure the rights for additional content, and diversity all over the world have resulted in these companies mobilizing hundreds of Crores of capital and are mainly spent in purchasing these contents. These platforms now throw a great challenge to the traditional media service providers like cinema theatres, etc. Practically every day thousands of subscribers are getting added to these platforms in India.

8.2 Their operating model is quite simple. They have two ways of generating the content which are mainly movies and serials. First they purchase the content from various production houses and most of the times even before the movies are released. For this they enter into detailed agreements for purchasing the movies' digital rights. Second, they produce their own content. They hire a production team and pay a lumpsum amount to these creative production houses to produce the type of movies which they specifically want. These production houses subsequently take care of all aspects of producing a movie. The same strategy applies for serials also. Their

income is solely depends on the subscription amounts they receive from the customers. Since there is heavy competition among these service providers, their sole concentration is to capture the bulk of market share and are not thinking about making profits right now. So they are investing heavily in purchasing and producing the contents and since the subscriptions are not commensurate with the expenses incurred, most of them are likely to show heavy losses. There are likely to be many Transfer Pricing issues which the TPOs should concentrate. Most of the service providers in India like Amazon and Netflix are purchasing the content from their Associated Enterprises (AE) counterparts in US and Europe and the price with which they are being purchased needs to be closely scrutinized by the Transfer Pricing Officers.

9. DIGITAL/ SATELLITE/ MUSIC RIGHTS AND OTHER EARNINGS

9.1 of late digital rights and satellite rights have gained so much importance in the media industry. While collections at the box office remain a key source of revenues for movies in India, a number of other drivers are fast becoming important sometimes even deciding whether a movie will become profitable.

9.2 Digital rights refer to the relationship between copyrighted digital works (such as film, music and art) and user permissions and rights related to computers, networks and electronic devices. Digital rights also refer to the access and control of digital information. Satellite right is the legal permission given by the producer of a film to a Television channel to show (broadcast) the film in TV. It might be for a limited time period or for lifetime. There will be many Clauses and conditions like the film can be shown in TV only after a particular time period etc. Some factors affecting the average cost for these rights are film cast, production banner (some established production houses can sell their films on higher rate to channels than any new production houses), past record of the people associated with the film, success or expectation of the film. It also depends on the buzz it creates before the release and the cost will be high also if the film is a blockbuster.

9.3 Gone are the days when movies were released only for theatres or television. VOD (videoondemand) and OTT (overthetop) platforms have opened up different channels through which your film can reach out to a targeted audience. These platforms work on subscriptions or advertisements, while the content owners can sell digital rights of movies to these online channels or media platforms. Big players are constantly looking for good engaging content. Times have changed drastically and movie distributors in India are not just looking for theatrical releases. Since the digital networks like Amazon Prime, Jio, Netflix, Zee5, Sony, Hotstar etc., are penetrating the entire country in an exponential manner, the digital rights have gained a huge value and there is a stiff competition among these players to purchase quality content. Most of the digital rights are purchased by the above players in India. However, since it will take some time for these players to penetrate rural India, production houses recover a major portion of their costs by selling satellite rights. Satellite rights are mainly purchased by the TV channels. Similarly, music rights and other miscellaneous rights also play an important role for the production houses in making profits out of the movies produced by them. In all the rights, TDS is deducted when payments are made for the transfer of the rights, be it digital or satellite. Many times, the payments for rights like digital are received by the producers over a period of time like 3 years and they offer the revenue over the same time period. However, from the Income-tax angle, the income is accrued to the producer in the year in which the agreement is entered into.

9.4 A survey was conducted on the producer of a blockbuster movie. During the course of survey, it was found that Sale of Digital rights for the film to Netflix was not accounted on accrual basis. Agreement value for the sale of digital rights was 6.5 million USD. After pointing out and questioned, the assessee offered the entire income for taxation in the current year. The agreement said that payment would be made by Netflix in equal instalments over a period of three years and the asseseee was intending to defer the accounting of the income. However, the agreement also clearly stipulated that the entire digital content rights has been transferred in the current year itself and hence the entire income ought to be offered in the year in which the agreement was entered. After the survey, the assessee paid tax of Rs. 10 Cr immediately.

10. FILM FINANCING

Filmmakers get their films financed through many options. Some are obtaining loans from banks, presell distribution rights, getting financial backup from large studios and production houses, find equity funding etc.

10.1 Raising Loans from Banks and Financial Institutions: Filmmakers are nowadays offering the distribution rights of their movies to distributors for certain regions even before the movie goes into production. Once these rights have been presold, they are using these contracts to go to a bank and raise a loan. Distributors don't pay up front with the entire amount, but their guarantee to pay once the movie is complete serves as collateral to the banks. This, however, works best for established producers. First time filmmakers might find it hard to raise funds this way. They can instead get a loan from a bank by providing a substantial security of their own.

10.2 Investment by Big Studios and TV Channels: This is the best possible approach for any aspiring or established filmmaker. Getting the backing of a large studio or production houses gives them the financial and intellectual muscle needed to execute a project as intensive as making a film. Big studios such as Yash Raj and Mukta Arts have already invested in the infrastructure needed and have the network and risk appetite to take on more and more film making projects. Of late, corporate production houses like ZEE, Viacom18 Motion Pictures, Reliance etc., have ventured and are behind the financing the big ticket films. Once a big studio steps in, the filmmaker can go ahead and make the movie fully knowing that they have the backing of a solid movie business behind them.

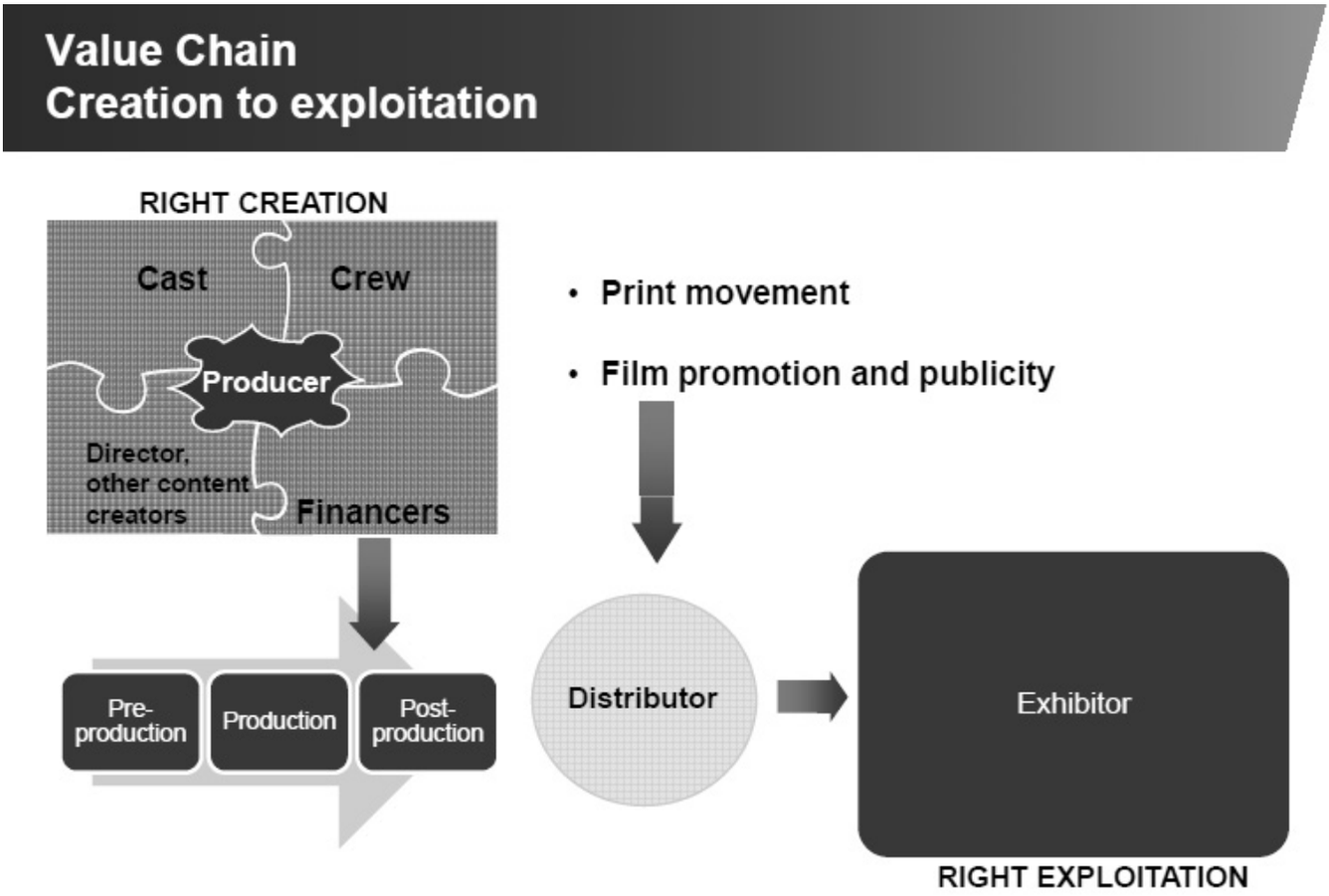
10.3 Private Equity: Raising the finance needed for the movie from investors requires an understanding of corporate law and having an excellent track record as a filmmaker. Nowadays, many companies which have huge capital are entering into the film world. Reliance Entertainment, for instance, is one such large company that has made a foray into films. They are not a traditional movie studio but work with a lot of producers to make movies. The reason a company like Reliance would foray into entertainment is that they can expect a large and quick return on their investment. Traditionally, companies consider 1520% return per year on the capital they have invested to be a good number. Since the return could be a lot higher and quicker in film making and distribution, they have begun to actively consider film making as an investment opportunity.

10.4 Digital Service Providers (VOD and OTT Platforms): In recent years, many OTT and VOD providers like Netflix and Amazon Prime are financing the production houses to produces their own films and which are released through their own platforms.

10.5 Crowdfunding: With online communities becoming a huge part of the internet, people are putting forward financial support for ideas that resonate with them. Some crowdfunding platforms in India helps aspiring film makers and artistes find the funds they need and some movies are financed in this way.

11. FLOW OF INCOME IN MOTION PICTURE INDUSTRY

A movie produced by a Production House is nothing but its intellectual property. The rights of a movie are exploited by exhibiting it for the audience. This value chain is diagrammatically represented hereunder:



Now-a-days upto 70% of box office revenue is contributed by large theatre chains which have a panIndia presence. The business models are explained in brief hereunder:

11.1 Sharing of Revenue between Producer and Distributor

a. Minimum Guarantee Plus Royalty Model: The distributor acquires the right to distribute the film in a particular territory, for a limited period, by paying a minimum guarantee to the producer. The excess of distributor revenues over the minimum guarantee, print and publicity costs i.e. 'overflow' is shared with the producer in a preagreed ratio.

b. Commission/ Revenue Share Model: The distributor retains a commission on the total amount collected from the exhibitor and remits the rest to the producer. The distributor may pay a recoverable advance to the producer, while acquiring the distribution rights. Such advance is usually adjusted against the remittances to be made to the producer.

c. **Outright Sale Model:** The distributor purchases the entire rights for the territory from the producer.

11.4 Sharing of Revenue between Distributor and Exhibitor

a. **Revenue Share Model:** The box office collections, net of entertainment tax, are shared between the distributor and the exhibitor in a preagreed ratio. The entire risk of box office performance of the film is shared between the distributor and the exhibitor.

b. **Theatre Hire Model:** The exhibitor collects the entire box office collections, net of entertainment tax. He retains a fixed amount and hands the balance net collection to the distributor. The entire risk of box office performance of the film is borne by the distributor.

c. **Fixed Hire Model:** The distributor receives a fixed amount per week from the exhibitor, irrespective of the film's performance at the box office. The entire risk of box office performance of the film is borne by the exhibitor

d. **Fixed Hire Plus Royalty Model:** The distributor receives a minimum guarantee from the exhibitor. Any box office collections, net of entertainment tax, in excess of the minimum guarantee amounts are shared between the distributor and the exhibitor in a preagreed ratio

12. REVENUE RECOGNITION

Now, based on the revenue sharing models, revenue recognition norms can be broadly be as under:

12.1 Producers

a. In case of non-refundable minimum guarantee contracts and outright sale contracts, the minimum guarantee or sale amount should ordinarily be recognised as revenue on the date of the agreement or at such time as the common principles of revenue recognition are satisfied. However, the Producer shows the income as per provisions of Rule 9A of the Incometax Rules, 1962.

b. In case of commission contracts, revenue is recognised as it is earned from the exhibition of the film.

12.2 For Distributors

a. Distributor's share from theatrical exhibition is recorded as revenue as it is earned from the exhibition of the film.

b. Revenue is recognised net of entertainmenttax and exhibitor's share.

12.3 For Exhibitors

a. Exhibitor's share from theatrical exhibition is recorded as revenue as it is earned from the exhibition of the film.

b. Revenue is recognised net of taxes and trade discounts.

13. TAXATION ISSUES IN MOTION FILM INDUSTRY

13.1 Amortization of the Cost of Production for Film Producer: It is guided by Rule 9A which is a provision exclusively for the Film Industry. This Rule deals with the amortisation of Cost of Production ('COP') for a film producer. Rule 9A(1) provides that:

> *"In computing the profits and gains of the business of production of feature films carried on by a person (the person carrying on such business hereafter in*

this rule referred to as film producer), the deduction in respect of the cost of production of a feature film certified for release by the Board of Film Censors in a previous year shall be allowed in accordance with the provisions of subrule (2) to subrule (4)."

As per Rule 9A sub rule (2), (3) and (4) deduction is allowed in respect of cost of production of a feature film certified for release by the Board of Film Censor in the previous year and if the film is released at least 90 days before the end of the relevant year. In case if film is released within 90 days, no loss is allowed.

13.2 As Per Rule 9A, COP Means:

a. All the expenditure incurred on the production of the film, except:
   (i) Expenditure incurred on preparation of positive films.
   (ii) Expenditure incurred on advertisement of the film after Censor certificate.
b. Subsidy received from the government will have to be reduced from the cost.

The implication thereof is as under:

a. A film producer can claim a deduction for the cost of production of a feature film certified for release by the Board of Film Censors in computing the profits and gains of the business of production of feature films.
b. No deduction is allowed in the event the film producer fails to exhibit the film in the year of its production. In this case, the entire cost of production is carried over and allowed as a deduction to the following tax years.
c. The cost of production is the expenditure incurred on the production of the film but does not include any expenditure incurred for preparation of the positive prints of the film and advertisement of the film.
d. Sale of Exhibition Rights: A film producer can claim a deduction for the entire cost of producing a feature film certified for release in the year of its production. However, the deduction is available only if the exhibition rights are also sold during the same tax year.
***e.* Part-sale of Exhibition Rights:** If the film producer exhibits the film in certain areas and sells the exhibition rights in the remaining areas in the year of its production, the entire cost of production is allowed as a deduction only if the film is released for exhibition at least 90 days before the end of the same tax year. If the film is not released, the cost of production is allowed as deduction in the same tax year only to the extent of aggregate amounts realised by the film producer by exhibiting the film and by the sale of the exhibition rights. The balance, if any, is carried over (and allowed as a deduction) to the following tax years.
f. It is also to be noticed that the benefit of Rule 9A is available only if the realizations are credited by the producer in the books of account regularly maintained.

13.3 The concept of Rule 9A is summarized in following Table:

Censor Board Certification	Exhibition/ Sale of Rights	Release 90 days before the end of the Financial Year	Deduction of 'Cost of Production'
Completed	Completed	Completed	Full Deduction
Completed	Completed	Not Completed	To the extent of Amount Realised
Completed	Not Completed	Not Completed	No Deduction in the first year. In the second year, the whole of cost of production is amortized whether the film is exhibited or not.

13.4 As per Rule 9A(5), deduction for cost of production of a feature film certified for release, will be allowed when producer exhibits the film of commercial basis or sells rights of exhibition and realization therefrom is credited in the books of account. Hence, the Assessing Officer should investigate and ensure that no cost of production if a film is allowed prematurely prior to the commercial release of the film and prior to the proceeds being credited to the books. While Rule 9A(5) is for film producers, Rule 9B(5) applies to a film distributor. Accordingly, in their assessments too, the Assessing Officer should verify to rule out the possibility of inadmissible deductions being claimed anterior to the incomings being credited to the books of account.

13.5 In Mumbai, one case came to notice which involved the issue of interpretation of Rule 9A and exhibition of movie on television exclusively. The assessee, a reputed Production company, desirous to reduce its taxable profit earned through the production of one movie "G" which was released during the year and was declared superhit, sought to offset it by the loss incurred on movie "A". When the Assessing Officer required the details of loss incurred on movie "A", the assessee stated that the company had produced film 'A' for release on TV. On further verification, it was revealed that the assesseecompany had entered into an agreement with the television channel in the month of February for sale of satellite rights of the movie "A". However, the said movie was not telecast during the year. Although it had received Censor Board Certificate, the Assessing Officer held that the assessee was not eligible for setting off such loss with profit of film 'G'. The loss disallowed for the year under consideration, was, however, allowed in the next assessment year.

13.5.1 On appeal, the Tribunal noticed that the assessee had taken a certificate from the Central Board of Film Certification, which was valid for theatrical release of film "A". Hence, it was not clear that how a film produced for theatrical release, having a different material/technology, could be claimed to have been produced exclusively for TV telecast and if it was not so, then, why was the certificate from the Censor Board, obtained. The assessee had claimed that this film was produced for TV. However, as per commercial practice, films are produced in such a manner only when the producer enters into exclusive arrangement beforehand and the cost of production as well as consideration for telecast rights is also settled beforehand. However, in the instant case, the assessee had entered into assignment agreement with Television channel much after the date of production as well as approval by the Censor Board. Hence, in the absence of any material on record to show the contrary, claim of the assessee that this film was produced exclusively for TV was also rejected. The ITAT also held that the exhibition on TV had also been exploited on a commercial basis. Hence, exhibition of films on television, fell within the ambit of rule 9A.The ITAT concluded that the Assessing Officer, having regard to the fact that the film was released for exhibition for

less than 90 days, had rightly reduced the cost of production by the amount realized by the assessee and had carried forward the balance to the next year wherein it had been allowed as a deduction.

13.6 Some Important Case Laws Related to Rule 9A/ Section 37

a. ***CIT vs. Prakash Pictures*** **(260 ITR 456)(Bombay HC):** The assessee is required to claim expenses yearwise to the extent of income which the assessee estimated for the unexpired period of contract, even for claiming the expenses under Section 37(1) of the Act.

b. ***Firoz Nadiadwala vs. Addl. CIT*** **[143 ITD 551 (Mumbai Trib)]:** As per rule 9A, which provides for computation of income from exhibition of feature films, interest on loan borrowed specifically for production of a film, not released during year is not allowable, and should be carried forward to next year as cost of production

c. ***ACIT vs. Akineni Nagarjuna Rao*** **[22 Taxmannn.com 69 (Hyd.)]:** Interest on loan taken for production of film is to be capitalised and allowed under rule 9A only in year of release of film

d. ***Dharma Productions Pvt Ltd vs. DCIT*** **(42 Taxmannn.com 8);** ***Teja Cinema vs. DCIT*** **(56 tamnann.com 432)** Expenditure incurred in preparation of positive prints and advertisement, for purpose of production of film is allowable as business expenditure under Section 37(1).

e. ***ITO vs. Shakti Samanta*** **(3 ITD 546) (Bom.):** As per Rule 9 A,if sale of rights of exploitation was not in respect of all the specified territories, the entire cost of production of a feature film would not be allowed in computing the profits and gains and part of the cost is to be treated as closing Stock.

f. ***Sagar Sardhadhi vs. ITO*** **(18 Taxmannn.com 348 (Mum.):** The valuation of closing stock has to be made as per Rule 9A and the assessee cannot claim artificial reduction in the value of closing stock even if the assessee cannot sell the movie produced by him.

g. ***Suneel Darshan vs. ITO*** **(2 SOT 753 (MUM.):** Income arising on sale of music rights of a film is outside purview of rule 9A.

13.7 Abandoned Films: Deduction of cost of production of films certified for release by the Board of Film Censors is available as per Rule 9A. In case of films abandoned, a certificate for release from the Board of Film Censors is not received. The CBDT has clarified through CIRCULAR NO.16/ 2015 that cost of production of abandoned films should be treated as a revenue expenditure and deduction allowed under Section 37 of the Act.

13.8 Post-production Fees: At times, Post-Production work including VFX is outsourced to a foreign company and the Indian film producer pays Post-Production fees to such foreign company. The issue which arises in such cases is whether such Post-Production payments amounts to "fees for technical services" under the relevant tax treaty/ domestic tax laws and, accordingly,trigger withholding tax applicability (TDS). This would depend upon the specific services provided, documentation of the same in the contract, and the relevant tax treaty provisions.

13.9 TDS Compliance: It is important to note that TDS deduction at the correct rate and its subsequent deposit is an area of default with the film industry and the same must be carefully scrutinised. This should be done on the facts of the individual agreement, the Circulars of the Board and the extant interpretation of law by the Courts.The correct applicability of either Section 194C or Section 194J of the

Act on a host of payments such as taking out final negatives of film, dubbing expenses, print processing fee, hiring of equipment, labour and operators for production purposes, payment for Post-Production professional services, including payments made to overseas entities, etc., ought to be examined. For payments made to overseas entities, the applicability of the DTAA and existence of a PE in India may also be kept in mind.

13.9.1 Further, royalty payments are subject to TDS provisions under the Act. Such payments are fairly common in the film industry given the multiple deals relating to music rights, distribution rights, overseas rights, satellite and video rights, etc. Thus, the Assessing Officer may not consider the aforesaid from the angle of infringement of Section 40(a)(ia) of the Act, but also consider communicating the default to the Assessing Officer of the payer. Failure to do so has invited in the past, audit objections involving large underassessment quantum.

14. FILM DISTRIBUTOR

14.1 Deduction for the Cost of Acquisition (Film Distributors)

a. **Rule 9B:** The film distributor can claim a deduction for the cost of acquisition of a feature film in computing the profits and gains of the business of distribution of feature films. No deduction is allowed if the film distributor fails to exhibit the film in the year of its acquisition. In this case, the entire cost of acquisition is carried over (and allowed as a deduction) to the following tax years. The cost of acquisition, in relation to a feature film, means the amount paid by a film distributor to a film producer for acquiring exhibition rights.

b. **Sale of Exhibition Rights:** A film distributor can claim a deduction for the entire cost of acquisition of the film in the year of acquisition (subject to the sale of exhibition rights by the film distributor in the same tax year).

c. **Part-sale of Exhibition Rights:** If the film distributor exhibits the film in certain areas and sells the exhibition rights in the remaining areas in the year of its acquisition, the entire cost of acquisition is allowed as a deduction only if the film is released for exhibition at least 90 days before the end of the tax year. If the film is not released, the cost of acquisition is allowed as a deduction in the year of acquisition only to the extent of aggregate amounts realised by the film distributor by exhibiting the film and by the sale of the exhibition rights. The balance, if any, is carried over (and allowed as a deduction) to the following tax years.

14.2 The concept of Rule 9B is summarized in following Table:

Exhibition/ Sale of Rights	Release 90 days before the end of the Financial Year	Deduction of 'Cost of Acquisition'
Completed	Completed	Full Deduction
Completed	Not Completed	To the extent of Amount Realised
Not Completed	Not Completed	No Deduction

The accounts may also be perused to see whether the assessee following the mercantile system, has unjustifiably spread the consideration received from sale of satellite or other rights over a number of succeeding years, whereas, he should have offered it as a taxable receipt in the financial year in which the sale was finalised.

14.3 The Assessing Officer may apply his mind to the debit of the entire cost incurred in purchasing rights of a feature film as business inventory, rather than capitalizing the same and claiming depreciation for intangible assets in light of Exlanation3 to Section 32(1) of the Act.

14.4 In the case of *M/s Malyala Manorama Co. Ltd vs. ACIT* [(2013) 40 Taxmannn.com

380 (CochinTrib)], the issue of applicability of Rule 9B was considered. The assessee, in this case, had claimed deduction under Rule 9B(4) of the Act at Rs. 77,50,000/, being the cost of acquisition of the satellite and terrestrial television rights of five Malayalam films acquired during the financial years 200405 to 200506. The Assessing Officer noticed that the assessee did not make commercial use of the said films in any of the aforesaid financial years. Hence, no income was generated out of the acquisition of film rights. The Assessing Officer noticed that, as per Rule 9B, generation of income either in the year of purchase of rights or in the subsequent year is a primary condition for allowing deduction either in the year of purchase or in the succeeding year. Accordingly, the AO held that the question of deduction of cost of rights of films purchased during the year under consideration didnot arise. Similarly, he held that deduction of cost of rights acquired in the earlier years and brought forward during the current year also did not arise at all. Accordingly, he disallowed the amount of Rs. 77.70 lakhs claimed under Rule 9B(4). The findings of the AO were upheld by the Cochin Tribunal.

14.5 Other Issues in Distributor's Case: One legal issue which has emerged in the case of a distributor is that of whether the payment for purchase of satellite broadcasting rights constitutes 'royalty' or outright purchase. The Courts have given judgments favouring both the interpretations considering the underlying facts. In the case of *ACIT vs. Shree Balaji Communications* [(2013) 30 Taxmannn.com 100 (Chennai Trib.)], the assessee had debited a sum of Rs. 25.71 crore for purchasing satellite rights of films and programs. The AO was of the opinion that such agreements were only for assignment of rights and not for sale of right to assessee. The rights were only for 20 to 25 years and were not of permanent nature. He concluded that Section 194J was applicable since payments were in the nature of royalty. As no TDS had been made, the Assessing Officer invoked Section 40(a)(ia). On appeal, the Tribunal held that the assessee did not purchase the cinematographic films as such through the transactionsandhad only received right for satellite broadcasting. Even if the transfer of rights is perpetual or even if the transfer is only a part of the rights, as long as transfer is of any right relatable to a copyright of a film or video tape, which is to be used in connection with television or tapes, the consideration paid would ordinarily be royalty.

14.5.1 However on different facts, the Hon'ble *Madras High Court in K. Bhagyalakshmi vs. DCIT* [(2013) 40 Taxmannn.com 350, observed that where assessee acquired satellite television rights of some films for a period of 99 years under irrevocable deed of transfer with a liberty to telecast said film without any liability and even with a further right to assign in favour of third party copyright to broadcast said films, it was a case of sale of satellite television rights and, thus, payment made for same would not fall within definition of 'royalty' as per subClause (v) to Explanation 2 to Clause (vi) of Section 9(1). Thus, the issue needs to be considered as per the facts in each case and the liability for TDS to be determined, accordingly.

15. Film Exhibitor Entertainment Tax Subsidy: One important legal issue settled by the Hon'ble Supreme Court was whether Entertainment Tax subsidy was Capital or Revenue in nature. Entertainment Tax is subsidy given by the State Governments to the Multiplex Cinema owners. Entertainment Tax is part of the ticket price and collected by the multiplex theatres from the viewers and paid to the respective State Governments. In order to give incentive entertainment tax collected is allowed to be retained by way of subsidy for certain initial years of operation of multiplex theater complex. The assessee treated this subsidy as capital receipt; while the Revenue treated this as revenue receipt. This issue has now been settled

by Hon'ble Supreme Court in the case of *CIT vs. Chaphalkar Bros* [(2017) 88 Taxmannn.com 178, wherein it was held that the Entertainment Tax subsidy received by the Exhibitors is capital in nature.

15.1 Section 80IB(7A) of the Act read with rule 18DB, relates to deduction available to multiplex owners.

16. MISCELLANEOUS TAXATION MATTERS

16.1 In Mumbai, in one particular case, it was observed that the assessee, which was engaged in the business of renting of digital cameras to the Production Unit had claimed depreciation at the rate of 60% thereupon on the reasoning that the cameras were computer peripherals and without software, they were not workable. Thus, depreciation was claimed at the rate admissible for computers. The Assessing Officer repudiated this by demonstrating that a movie camera is used to take a rapid sequence of photographs on an image sensor or on a film or digitally. Although aided by computer and software, it is never a part of the computer network itself. Moreover, a movie camera in no way helps and aids the computer to carry out its logical, arithmetic and memory functions.

16.2 A similar issue came up in the case of *Cinetech Entertainment India Pvt Ltd vs. ITO* [(2018) 90 Taxmannn.com 366 (MumbaiTrib)] wherein the Tribunal upheld the order of the Assessing Officer who rejected the claim of higher depreciation on Film Projectors.

17. ISSUES RELATED TO INDIVIDUALS ARTISTS

a. Revenue Recognition

b. Deemed rental income

c. Inflation of expenses

17.1 In Film industry, professionals receive the income after deduction of tax. Most of the payments are received from Recognised Production House and hence suppression of income in audited books is not common. However, income from foreign tours, participation in reality shows, endorsements and modelling may be understated and even suppressed entirely. For "film artist", the provisions of Section 44AA(3) read with rule 6F apply for the purposes of maintenance of books of account. From the perspective of examination of books of account in these individuals, the following issues deserve consideration:

17.2 Method of Revenue Recognition: In Film Industry most of the assessees prefer the Cash System of Accounting. However, this method of accounting brings with itself some of the most contentious disputes such as:

a. TDS Mismatch: Production houses follow mercantile system but assessee follow cash system, which lead to TDS mismatch at the time of assessment and also at the time of processing of the Return of Income.

b. Treatment of Advances: Many a times, the assessee receives an advance from the producer. However, the project does not commence till the yearend. This leads to the dispute as to whether the recipientartist should treat the advance as income following the cash system of accounting or whether it should be treated as an Advance in the Balance Sheet and offer it as income when the corresponding services are rendered. In one case, an actor had recognised revenue upon the release of the film. The Assessing Officer held that once the services were rendered against such advances, the same should be Recognised as income. The view of the Assessing Officer was upheld by the Tribunal.

17.3 Issue of Deemed Rental Income: It been frequently seen in the Film Charge that most of the professionals invest heavily in immovable properties and then take the

plea that these properties were being used for professional activities. The rental income being offered by them is also not commensurate with the market rents.

17.4 Inflation of Expenses: In case of movie artists, there is a thin line between professional and personal expenses. In some instances personal expenses were claimed disguised as professional expenses. In one case, the assessee had booked legal expenses towards personal work under the head legal expenses. The same was examined and added back by the AO and the order was upheld by the Hon'ble ITAT.

17.4.1 In another such case, large travel expenses, not commensurate with the assignments of the assessee, was claimed. Details of travels and corresponding assignments should be called for in such cases.

17.4.2 In the case of one reputed singer and producer, the details of foreign tour expenses claimed was tallied with the details of foreign shows performed by the assessee along with the dates of foreign shows. Once this data was tabulated by the Assessing Officer, it was found that the expenditure booked were on dates which were at variance with the dates of foreign shows. Consequent thereto, the claim made was disallowed. This addition was subsequently confirmed by the ITAT.

17.4.3 In one case, the actor had booked publicity expenses towards the movie in his books. On scrutiny of the relevant contract it was seen that the promotion and publicity of the movie was not the responsibility of the actor and as such he was under no obligation to perform the same. The same was accordingly disallowed and the said order was upheld by the Hon'ble ITAT.

18. Foreign Incentives: Many Indian production houses shoot movies in foreign locations. By doing this, they receive twin benefits of shooting in exotic locations and also receiving subsidies from various governments. In this regard, the *modus* is to incorporate a company abroad. The production of the movie occurs through this company and the entire expenses are booked there. To this effect, the producer hires a local line producer and makes payments to him. Finally, upon the completion of the production, the Indian company purchases the movie from the foreign company. At the end of the production, the company presents its complete accounts to the respective foreign governments who grant the subsidy/incentive as per their policies. In suitable cases, where the foreign incorporated company is an AE, the AO/TPO may apply the TP provisions. In appropriate cases, where the foreign company is not an AE, then the AO may consider making a reference to FTTR, CBDT as per the manual of exchange of information. This incentive may be passed on to the Indian producer. The agreements between the Indian Producers and the foreign company/ line producers should be scrutinised in this regard.

19. TAX EVASION ISSUES FOR INVESTIGATION

19.1 Producer: The source of money for a new movie should always be deeply scrutinized. There have been instances where the capital has been raised from the tainted or dubious entities. The unsecured loan introduced in the Balance Sheet of the producer should be the focus area for investigation.

19.1.1 The producer also makes certain inadmissible, illegal expenses/payments in cash, mostly for approvals, outdoor shooting including cash remuneration. This cash is generated by debiting bogus expenses in books. Hence, to examine this issue, the production expenses should be carefully scrutinized.

19.1.2 There have been instances where the singers were found to be in receipt of unaccounted cash earned from private shows including marriage functions. This cash to singers

is generated by debiting bogus payments to fictitious musicians (say, the payment was actually made to a troupe of 10 people, whereas, the vouchers were created for a troupe of 20 people).

19.1.3 Another mode of cash generation is to debit bogus marketing and advertisement expenses in books. This practice is mostly prevalent in shortfilms or advertisement shoots companies, where they debit bogus advertisement expenses and generate cash therefrom.

19.1.4 Producers are also found debiting production expenses as nonproduction or overhead expenses. This is done as production expenses are liable to be amortised, but by claiming certain expenses as nonproduction expense the assessee deducts the entire expenditure in a single year.

19.1.5 It is necessary to scrutinise the basic documents which the Film Production Unit uses for its daily activities to examine the expenses claimed. Some of these basic documents are as under:

a. **Continuity Report:** It is prepared by the assistant director which gives details of all the scenes actually shot. This report is prepared with the purpose of preparing the next shot in continuation of earlier shot. Therefore, all the minute details are mentioned in this report. On the basis of this report, expenses related to setting expenses, location and material used during the shooting can be verified. A Typical Continuity Report is as under:

CONTINUITY LOG BOOK: **PAGE NO.:**

XYZ PRODUCTIONS

"MOVIE NAME"

DIRECTOR: ABC **DOP: DEF**

<table>
<tr><td colspan="2">Shoot Day No.:</td><td colspan="2" rowspan="2">Shift:
First Shot:
Pack Up Time:
Meal Break #1:
Meal Break #2:</td><td rowspan="2">CAM 1:</td></tr>
<tr><td colspan="2">Shoot Date:</td></tr>
<tr><td colspan="2">Shoot Location:</td><td>Scene No:</td><td>I/E:</td><td>FPS:</td></tr>
<tr><td colspan="2">Set Location:</td><td>Slate:</td><td>D/N:</td><td>Lens/Distance</td></tr>
<tr><td colspan="2">Action:</td><td colspan="2"></td><td>Aperture:</td></tr>
<tr><td colspan="2">Description:</td><td colspan="2"></td><td>Filters:</td></tr>
<tr><td>Shot</td><td>Take</td><td>Chip & Clip No</td><td>Remarks</td><td>Continuity Notes</td></tr>
</table>

CONTINUITY SUPERVISOR: _____ SIGNATURE: _____

b. **Call Sheet:** The daily call sheet is a filmmaking term for a sheet of paper issued to the cast and crew of the film production, created by an assistant director, informing them where and when they should report for a particular day of shooting. The scrutiny of the call sheets may help in verifying the expenses made by the producer towards junior artists and extras.

MOVIE: XYZ							
Production House: ABC							
Producer: Director: Director of Photography: Executive Producer:							
Call Sheet Day: –							
Production (India): Production Controller: Production (India)							
Weather: Cloudy and Rainy Hi: 28 C Lo: 26 C				Crew Call 12:00 Pm Shoot Call 02:00 Pm			
Sunrise: 06:10 AM				Lunch 12:00 PM			
Sunset: 18:49 PM				Snacks 05:00 PM			
				Dinner 09:00 PM			
Shoot Location				Base			
Haji Ali Juice Centre Mahalaxmi Mumbai 400 038				Heera Panna Shopping Centre			
SC	Location	I/E	SET	Synopsis	D/N	PGS	Cast ID
PBS	Juice Centre	I		Having Juice	N		1, 3
NO	Character	Artist		Hair/MUP	Costume	Set Call	
1	AYAN	DEF		12:30 PM	01:00 PM	01:30 PM	
2	IRA	NOP		09:30 AM	12:00 PM	01:30 PM	

Dancers	Hair/ M UP	Costume	Set Call
.			
Model Agency	Hair/M UP	Costume	Set Call
.	11:30 AM	12:30 PM	01:30 PM
Background	HAIR/M UP	COSTUME	SET CALL
30 Casted (11 X Boys, 19 X Girls)	11:00 AM	12:30 PM	01:30 PM
90 X MIX Crowd			
60 X Indian Model (40 X Boys, 20 X Girls)	12:00 PM	01:00 PM	01:30 PM

Chief Assistant Director

REQUIREMENT

Art_____

Juice Glass with fraj

Production_____

Umbrellas to be on stand by for actors.

Tea,Coffee, Water to be on Unit Base/Set

at all times

Nagra on set

HANDBLOWERS x 4

Hair/Make Up_____

Props_____

Electric_____

As per DOP

Grips_____

Catering_____

As per Production

AD Dept_____

Camera & Equipment_____

2 x sony F65

All camera bodies, lenser and kit to be carried PRIME FOCUS

PANTHER DOLLY

STEADICAM

JIMMY JIB

Sound

Art_____	**Props**_____	**Camera & Equipment**_____
Ayan As per Hair and Makeup Artist		N/A
Ira as per Hair and Makeup Artist		
Costume_____		Making(A)/ Still(B)
Ayan as per …..assisted by ……		A) As per Film Tent
		B) As per …..
Ira as per ….. assisted by ……..		Security/ Wakies
Please Carry Personal Character Bags and Accessories.		Special Requirement
		4 x haze machine
		6 x speakers from RJ disco on standby

c. Budget Estimate: Every producer, before starting of a movie, prepares an estimate of budget under each and every head of film making. The producer, having indepth knowledge of the film industry and mindful of the resources at his disposal, prepares a realistic headwise budget. Hence, the budget estimate is very important to see and benchmark whether any expenditure has been unduly inflated by the producer.

19.2 Distributor

19.2.1 In the case of the distributor, a common *modus operandi* is in the form of raising of unsecured loans from his related concerns. Sometimes, his own unaccounted money is routed through these entities or sometimes, the distributor borrows cash from market, introduces it in the bank accounts of relatives and then takes entry back from them as unsecured loans.

19.2.2 It is also a common practice of distributor making cash payments to the exhibitors who own cinema theatres. This cash is generated by the distributor by debiting bogus publicity expenses in its books. It is the primary responsibility of the distributor to promote the movie through advertisement and marketing. These publicity expenses are then to be shared between distributorsexhibitors and producers. Thus, the major chunk of indirect expenses in the books of the distributor represents publicity expenses. The distributor can suppress its income or can extract higher receipts from producer/ exhibitor by debiting bogus publicity expenses in its books. Another way of suppressing of income is by debiting bogus salary and travel expenses.

19.2.3 As soon as the movie is declared a hit, producers and distributors bring in intermediaries to divert profit. A distributor acquires world rights for a particular territory, then shows that he has raised finances by selling those rights to subdistributors for a part of his territory. Such sales offers scope for manipulation by way of bringing in unaccounted funds by passing off profits of distribution to *benami* parties.

19.2.4 When a film flops, it is purchased on a minimumguaranteebasis by a distributor, who may have suffered losses in earlier years as well. To help a near relative or sister concern having substantial income from their other business including distribution of feature movies, the distribution rights of the flop movie are transferred to relatives or sister concerns to reduce their tax liability through setoff.

19.2.5 In cases of commercially successful movies, distribution rights are passed on to a "Benamidar" or to a bankrupt dormant distributor. Such distributors set off huge profits against previous preexisting losses on the payment of small commission.

19.3 Exhibitor

19.3.1 A few exhibitors particularly that of Single Screen operators, organise the sale of tickets in the black market with the help of their own agents. This practice is prevalent particularly in small cities. In small and medium towns, the

exhibitors may underreport ticket sales or may not report some shows altogether. Some single screen operators run 6 shows for selected hit movies instead of usual 5 shows. The exhibitors then underreport the income of the 6th show altogether. Another common trick employed by singlescreen theatres is the addition of chairs in theatres over and above normal seating capacity for which tickets are sold, sometimes at higher rates and not accounted for.

19.3.2 There is also a tendency to understate the receipts from canteen contractor, from sale of food and beverages inside the theatre as almost all the receipts are in cash. Moreover, even the parking receipts collected by contractors employed at the theatre areoften underreported.

19.3.3 Instances have come to notice wherein the exhibitors have resorted to debiting of bogus expenses by claiming fictitious commission for procuring movies from distributors.

19.3.4 There are also instances where exhibitors had acquired exhibition rights in obscure movies and paying disproportionate amount for its exhibition thereby incurring losses just to reduce the profit during the year. Obviously, the transaction for obtaining rights for such a movie is highly doubtful and lacks commercial justification. The cash flows back to the exhibitor from the seller of movie rights, who charges a commission for arranging this transaction.

20. SOME CROSS-BORDER TAXATION ISSUES RELATED TO MOTION FILM INDUSTRY

20.1 Tax Implications of Production of a film as a joint Venture between an Indian & a Foreign Company: An Association of Persons ('AOP') is taxable at the maximum rate and payments to a member of AOP are not deductible in its hands. A member of an AOP is, however, not again taxed in respect of its share. It may be noted that after the amendment to Section 2(31) w.e.f. 01.04.2002, the objective of producing income is no longer relevant to constitute an AOP and common business purpose & common management are adequate. In the case of production of film on a Joint Venture the underlying agreement needs to be examined carefully to determine the correct assessment status as to whether an AOP has come into existence or not.

20.2 Indian Films Shot Overseas: It is common for Indian films to be shot overseas (partly or fully). Typically, in such cases,the Indian producer contracts with a line producer in the foreign country to assist with the shooting and the film on payment of a fee. In certain case, a view has been taken that such line producer fees amount to Fee for Technical Services and taxes should be withheld accordingly. Thus, this aspect may be examined based on the contractual terms (i.e. role/ responsibilities) agreed and documented between the parties in the context of interpretation of law by the judicial authorities

20.3 Foreign Films Shot in India: The tax implications should be evaluated for film producers/studios, actors (in front of the camera) and crew (behind the camera).The following aspects needs to be considered as per the obtaining facts and the prevailing legal view:

a. Whether the income of foreign producers is taxable in India in respect of operations confined to shooting of a film in India for transmission out of India?

b. Taxability of foreign actors is covered under DTAA of tax treaties (Taxation of entertainers and sportsperson). Income from personal services, as such, performed in India should be taxable in India irrespective of whether or not such actor is an employee. In case the performance income accrues not to the actor but to another entity, such income may still be taxable in India. This is an antiavoidance measure included in tax treaties.

c. Foreign crew would include all technicians. Taxability of their income should be evaluated based on applicable criteria such as the nature of services rendered, the legal form of entity, presence/ period of stay in India, relevant tax treaty provisions.

21. SOME PROVISIONS RELATED TO MOTION FILM INDUSTRY

21.1 Submission of Form No. 52A: As per the provisions of Section 285B, a producer of a cinematograph film is required to furnish a statement to the Assessing Officer in the prescribed Form 52A, giving details of all payments over Rs. 50,000/ made by him, or due from him to any person engaged by him in the production of a film. The statement has to be furnished within 30 days from the end of each financial year during which production activity is carried by him or within 30 days from the date of the completion of the production of the film, whichever is earlier. The object of this provision is to check whether the recipient have shown appropriate income or not.

21.1.1 The producer is required to file details in respect of all persons engaged by him in the production of the film. The words 'engaged' denotes someone whose services have been utilised for the production of the film. Thus, a question arises whether the same covers persons, who are supplying goods and materials. However, it would cover all artists, technicians and other persons engaged in the activity of actual production of the film.

21.1.2 If a producer fails to furnish such statement in Form No. 52A, then he is liable for penalty u/s 272A(2)(c) of a sum of Rs. 100/ for every day of default.

21.1.3 Form No. 52A has to be filed within 30 days from the date of completion of the production of the film. There may be two views as to the date of completion of the production of the film. One is that the last date of any of the activities relating to the completion of the film is the date of completion of production. The other view, is the date of issue of certificate by the Censor Board is the date of completion since the Censor Board may direct reshooting or editing of the film. Rule 9A which is exclusively meant for the Film Producer, refers to the certification by the Censor Board for recognizing the revenue. Thus, the prevailing view currently is that the date of completion of the film as referred to in Section 285B means the date on which the Censor Board issues the Certificate to the film.

21.1.4 However, it is a good assessment practice to verify the receipt of Form 52A and its contents prior to allowing expenditure on films. The purpose of introducing Section 285A was to check inflation of expenditure by film producers.

21.1.5 The Assessing Officers can examine the possible incidence of wealthtax since the corporate and individual entities typically have significant chargeable assets.

22. INSTRUCTIONS/ CIRCULARS RELATED TO MOTION FILM INDUSTRY

22.1 Instruction No. 1727, Dated 22.8.1986

Section 285B Film producers statements should contain all payments exceeding Rs. 5,000, and not merely such payments to employees and professionals.

22.2 Circular No. 544, Dated 15th September, 1989

Rule 9A whether subsidy received by producers of regional feature films, which has not been charged to tax, shall not be reduced from cost of production of the film

22.3 Circular No. 736, Dated 13.2.1996

Applicability of Provisions of Section 194I to Film Distributors and Exhibitors

22.4 Circular No.16/2015 [F. NO. 279/ MISC./140/2015ITJ], Dated 6.10.2015

Non-applicability of Rule 9A in case of abandoned Feature Films

CHAPTER

8

Broadcasting and Television Industry

1. INTRODUCTION

1.1 Broadcasting Services in the Indian context encompass multifarious activities like Cable TV Analogue and Digital; Direct to Home (DTH) services; TV Channels; Radio FM/AM/SW/ Community Radio and also Internet Protocol Television (IPTV) i.e. television that is delivered to the house over an IP Network, rather than over traditional satellite, cable or terrestrial networks. The IPTV services are delivered through a high speed access network like Digital Subscriber Line (DSL). The term IPTV should not be confused with the delivery of television over internet.

1.2 In the value chain for the broadcasting and cable TV service, the broadcaster is at the top. It provides broadcasting content to various entities like the Cable Operator i.e. the Multi System Operator (MSO) as well as the Local Cable Operator (LSO); the DTH Operator; the IPTV Operator and the HITS Operator. The HITS Operator also provides service to the Local Cable Operator. In turn all the MSOs, LSOs, DTH and the IPTV target the end consumer.

1.3 Presently the Television channels in India are mostly beamed through satellites and the TV signals reach the individual consumer either through a set top box via a dish antenna and/ or through MSO/Cable. In satellite TV broadcasting, the signals of TV channels are transmitted from an earth station to the geostationary satellite (uplinking) located in the space. A geostationary satellite has a very wide coverage (footprint) on earth, which may span several countries. The signals of TV channels transmitted from an earth station to satellite, after necessary amplification and encryption, are reflected back on very wide area of earth by transponders of the satellite. The Transponders are electronic systems mounted on a satellite which receive, amplify, encrypt and radiate signals. The signals are then collected on earth by receivers using a dish antenna (downlinking).

1.4 For setting up facilities for broadcasting of satellite TV channels a Wireless Operating License under the India Telegraph Act 1885 is needed. The FM radio broadcasting as well as the Satellite TV broadcasting also require the establishment, maintenance, and working of a telegraph. So, in a way both these businesses are also governed by the same statute.

1.5 For transmission of Satellite TV channels in India the Broadcasters use C band of the spectrum. The satellite beam covers a large footprint and the same set of frequencies are reused to communicate with different satellites placed at different positions in the geosynchronous orbit and, therefore, allocation of one set of frequencies for one satellite does not restrict the repeat allocation of same set of frequencies to another satellite positioned after providing for a certain minimum angular distance in the orbit. The orbital positions of the satellites are regulated by International Telecommunication Union (ITU) in coordination with member countries. The Broadcasters of the satellite TV channel stake on hire the transponder of a satellite for a contractual period from the owner of that satellite. Thus, the broadcasters have to bear cost of leasing transponder capacity.

1.6 The signals of TV channels are uplinked to the satellite through a teleport. A teleport is a satellite earth station which is used to uplink signals of large number of TV channels to a satellite. The Indian Government has issued policy guidelines for uplinking of television channels from India dated 5th December 2011 which contain provisions relating to grant of permission/ license for setting up of uplinking hub/ teleports in India. Till September 2017, the Ministry of Information and Broadcasting (MIB) had issued 74 permissions for setting up of teleports in the country. Also, till September 2017, MIB has granted permission to downlink to 881 private satellite TV channels. Out of these 881 TV channels, 797 TV channels are uplinked from India, and remaining 84 channels are uplinked from abroad.

1.7 At present there is no restriction on grant of license for setting up the teleports for uplink of signals of satellite TV channels. Further, the maximum number of channels which can be uplinked from a teleport depends upon the quantum of transponder capacity available for uplinking on a particular satellite. Therefore, the uplinking of satellite TV channels can grow without corresponding increase in number of teleports. As per the extant policy guidelines, teleport operators are permitted to use C band and Ku band frequencies for uplink of signals of satellite TV channels. However, most of teleports use C band frequencies for uplinking of satellite TV channel due to better transmission characteristics. Uplinking in C Band is permitted to both the Indian as well as foreign satellites.

1.8 For regulating broadcasting services, the Central Government has laid down policy guidelines for uplinking and downlinking of television signals. Under the policy guidelines for uplinking of television channels from India, the MIB issues the following types of permissions to companies registered in India for:

a. Setting up of uplinking hub/ teleports,

b. Uplinking of TV Channels (both 'News & Current Affairs' and 'NonNews & Current Affairs' categories),

c. Use of Satellite News Gathering (SNG)/ Digital Satellite News Gathering (DSNG) systems,

d. Uplinking by Indian News agencies, and

e. Temporary uplinking for any live event.

1.9 Similarly, under the policy guidelines for downlinking of television channels in India, MIB issues permission for downlinking of signals of TV channels from satellite on earth for further distribution to subscribers through various types of distribution platforms. As per FICCI KPMG IME Report 2017 the Television Broadcasting sector has more than 880 permitted satellite TV channels, around 80 Teleports, 7 DTH operators, 1500 Multisystem operators and large number of Cable TV operators. There are approximately 183 million TV households.

1.10 The FM Radio uses a different technology and no satellite is required for their transmission and reception. The FM radio broadcasting is a terrestrial form of broadcasting wherein for each Radio channel, 800 KHz bandwidth spectrum in the frequency band starting from 88 MHz to

108 MHz is allocated by the Wireless Planning & Coordination wing of the MIB. Due to certain technical restraints, in a given geographical area, maximum number of FM Radio channels permitted are about 15 and the auction for FM Radio channels is carried out geographical area wise. The risk of interference from the adjoining area transmitters also limits the maximum number of FM Radio channels in a given area. The reach of FM radio transmission is limited and it depends upon the transmitted power and height of the transmitter antenna. The details of operational private FM radio channels and the period of validity of their licenses are available on the website of MIB.

1.11 The MIB has also issued guidelines for operating HITS services in India in 2009. The HeadendintheSky (HITS) Broadcasting Service, refers to the multichannel downlinking and distribution of television programmes in CBand or Ku Band, wherein all the pay channels are downlinked at a central facility (Hub/Teleport) and again uplinked to a satellite after encryption of channels. At the cable headend, these encrypted pay channels are downlinked using a single satellite antenna, transmodulated and sent to the subscribers by using a landbased transmission system using cable/optical fibre network. After obtaining a HITS license from the Ministry, the HITS operator can himself contract with different broadcasters for buying the content, aggregating the same at an earth station and then uplinking with his own encryption to a satellite hired by him. The uplinked channels can then be downlinked by the cable operators using a dish antenna for onward distribution. In this model, the HITS operator works like a conventional MSO, except that virtually the headend is in the sky, instead of being located on ground. The HITS operator can also decide to merely provide passive infrastructure facilities like transponder space on satellite, earth station facilities and the provision for simulcrypting/ multicrypting of channels aggregated by different MSOs with different encryption system to one or more MSOs or to a consortium of cable operators/MSOs, as the case may be. The HITS operator in this case need not contract with the broadcasters for content. He only enters into contracts with one or more MSOs or consortium of cable operators desirous of uplinking their aggregated channels from HITS earth station(s) to the HITS satellite.

1.12 The Television broadcasting services is a capitalintensive business. Significant investment is required in production of programs, uplinking/ downlinking of TV channels, transponder charges, spectrum usage charges, network establishment, marketing and distribution cost, and other establishment charges. Further the cost structure of news, and nonnews channels vary significantly. It also requires continuous technology upgradation, and capability to face competition from within and outside India.

1.13 The grant of license for satellite TV channels at a fee, to be paid by the licensee, is a prerogative of the Central Government. Such fee usually has two components, the first is onetime fee commonly referred as entry fee, and the second is recurring fee commonly referred as license fee. Further, the license fee can be a fixed fee or variable fee or semivariable to be paid over regular intervals. There are different fees for uplinking/downlinking from India and uplinking/ downlinking from foreign soil.

1.14 The signals of all satellite TV channels having permission from MIB for downlinking can be distributed by registered Distribution Platform Operators (DPOs) – MSOs, DTH, IPTV and HITS operators to subscribers. The DPOs provide certain programming services also which are specific to each platform and are not obtained from satellitebased broadcasters. These programming services are either produced by the DPO itself or are sourced from certain groundbased broadcasters. The DPOs own programming services are referred to as Platform Services, which also includes 'localchannels'.

1.15 From a commercial point of view, each satellite TV channel is categorised by

its broadcaster either as a Pay Channel or a FreetoAir (FTA) channel. A Free to Air is one for which no fees is to be paid to the broadcaster for its retransmission through electromagnetic waves through cable or through space intended to be received by the general public either directly or indirectly. A pay channel is one for which fees is to be paid to the broadcaster for its retransmission through electromagnetic waves through cable or through space intended to be received by the general public either directly or indirectly. While for the distribution of pay channel, a fee is be paid and due authorization needs to be obtained by DPOs, for the distribution of a FTA channel, no fee is to be paid by DPOs to broadcasters. Accordingly, each broadcaster encrypts signals of its pay TV channels while broadcasting through satellite, so that only authorised DPOs, who have valid interconnection agreement with such broadcaster, are able to distribute signals of such TV channels. For distribution of FTA channel usually no specific authorisation is required by DPO from the broadcaster, as no fee is to be paid by DPO to broadcaster. Further, as per existing practice, signals of FTA TV channels are usually not encrypted while broadcasting through satellite, and accordingly any DPO can distribute such channels.

1.16 The above distinction has ramification for measuring subscriber base also. Encryption of all FTA channels in future would enable broadcasters to assess their subscriber base and then such data can be used by those broadcasters to optimise their rates for advertisements, and improve their revenue. It will also stop piracy by unauthorized operators.

1.17 Advertisements provide a significant portion of the revenue for the television industry. The broadcasters of the free to air channels (FTA Channels) rely solely on the advertisements as their source of revenue, while the pay channel broadcasters have twofold source of revenue in the form of advertisement and subscription revenues. This financial model had led to the broadcasters increasing the span of advertisement time on the television channels along with using larger screen space also. A main reason of this overdependence on advertisement revenue by the broadcasters was the nonaddressable nature of the cable TV networks, which forms the bulk of the cable & satellite TV universe in India. The nonaddressability had led to gross underdeclaration of the subscriber base and had resulted into a limited passthrough of the subscription revenue to the broadcasters. Thus, there was an increasing tendency on part of the broadcasters to meet out their costs and optimise profits through the advertisement revenue by pushing more and more advertisements. To address the constraints of nonaddressable TV systems, the Government has now enforced digital addressable cable systems in the country and it is expected that this would reduce the dependence on advertisement revenue. Further, in December 2018, the Telecom Regulatory Authority of India (TRAI) has issued a new tariff order which allows consumers to decide what channels he wants to watch and pay only for those. So far, broadcasters and distribution platform operators (DPOs) such as cable and DTH players used to offer a lumpsum number of channels for a fee. All this will change with the new order as the broadcasters will have to offer all the channels on alacarte basis at their maximumretailprice (MRP). While broadcasters worry that it will result in a drop of longtail or unpopular channels, the DPOs are worried that their share of revenue will come down. However, for the Assessing Officers it would mean more certainty of revenue and subscription incomes.

2. INDUSTRY STATISTICS

2.1 The calendar year revenue data indicates that the TV Channels industry stands at an INR 588 billion in 2016 and is expected to register a CAGR of 14.7% to reach INR 1,166 billion by 2021. The TV industry is dominated by the subscription and advertising revenue as under:

Table1: TV Industry Size

(INR billion)

Segments/Year	2014	2015	2016	2017*	2018*	CAGR (201621
Subscription Revenue	320	361	387	426	494	14.8%
Advertising Revenue	155	181	201	225	257	14.4%
Total print market	475	542	588	651	751	

(Source: KPMG **Projected)*

2.2 There were 183 million television households in the country in 2017, which makes India the second largest television market in the world. Within this universe, the cable subscriber base stood at 98.5 million in 2017, which is approximately, 53% of the total subscriber base. As far as number of channels are concerned, from a single stateowned channel i.e. Doordarshan in the 1990s, today there are over 850 permitted television channels (including about 400 news and current affairs channels).

3. MAIN PLAYERS IN TV CHANNEL INDUSTRY

3.1 The Industry is made up of the following players:

a. **Content Broadcasters or the TV Channels:** These are the ones who broadcast the TV content. The content may be in various forms such as news, soaps, serials, music, devotional, adventure, sports, movie entertainment etc. The activities of the Broadcasting companies can be summarised as under:

   (i) Purchase of "Content"

   (ii) Uplinking the content/ programme from earth station located in India or abroad.

   (iii) Downlinking the programmes, to be viewed through Cable Operators, DTH, IPTv etc by the users.

   (iv) Collecting advertising revenues from advertisers availing time slots for advertising.

   (v) Collecting share of revenue from Cable Operators/DPOs/DTH etc.

b. **Content Carriers or the Platform Operators:** The TV content is carried to the ultimate viewer by the various delivery operators who are termed Platform Operators.The delivery of the content happens largely through four platforms in India being Cable, DTH, IPTV and the Web.

c. **Content Producers or the Production Houses:** These refer to creation of the content. While some channels may have inhouse production capabilities, most of the content is produced by private production houses.

4. CONTENT BROADCASTERS OR TELEVISION CHANNELS

At present, based on their location status, three types of Television Channels are operating in the Indian market:

a. **Foreign Telecasting Companies:** These are companies located outside India whose broadcast footprint falls over India. These may be broadcasting fully localized Hindi content e.g. Star, Sony, etc. or they may have other language content like CNN, BBC etc.

b. **Indian Channels:** These beam content in India and these concerns are owned and operated by companies registered in India. These may include Hindi and Regional channels. They usually purchase/produce content, lease the transponder space and earn advertisement/ subscription income in India.

c. **Foreign Channels Beaming Outside India:** These are actually foreign channels which are owned and operated by foreign entities. Their India connection is that they have advertisement agents in India. These channels are mainly used by Indian exporters for advertising their products in overseas markets.

5. TAXATION ISSUES IN TV CHANNELS

5.1 The transmission and telecast of contents over a large terrestrial footprint by concerns operating in multiple jurisdictions involves issues relating to territorial jurisdiction for taxation and also characterisation of income. This industry has its share of tax litigation owing to the specific nature of crossborder business operations. It is patent that the usual source of Income accruing to the television companies is:

a. Subscription Income, and

b. Advertisement Income.

5.2 The advertisement/ subscription revenues earned by Indian telecasting companies are liable to tax on net income basis (as their worldwide income is taxable in India) at the prevailing rates.

5.3 The Foreign telecasting companies (FTC) are liable to tax in India if they have a permanent establishment or a business connection in India. The taxability in such case is only on the income, which is attributable to such operations carried out in India. The broadcasting organisations, whose head office are situated outside India, may operate in India either through a subsidiary or through an agent. Thus, for a foreign broadcaster its Indian subsidiary or agent, who acts on behalf of such foreign broadcasting organisation, is liable to pay tax on the revenues earned by the foreign principals. The taxability of advertisement revenues, where the same are collected though an Indian Agent also leads to the question of Agency PE for the foreign telecasting company. The offshore companies usually provide services in India through a licensing arrangement. The issue that arises from such transaction is whether such licensing arrangement would be taxable in India as Royalty or Fees for Technical Services and hence, any payment made by Indian licensee would be subjected to withholding taxes in India.

5.4 Concept of PE in Case of FTCs: The interpretation of the concept of Permanent Establishment (PE) under a DTAA is more restrictive in comparison to the concept of 'business connection' under the domestic laws. In many cases like sport events and mega shows etc. the FTCs and such other service providers design their contracts in such a way so as to avoid any footprint of the broadcaster in India in order to avoid constitution of a PE. However, invariably the local content generators, especially in sporting events, work at the instance and behest of the foreign broadcaster and the revenue is also generated locally. Under such circumstances, the functions, assets and risks of the local party is required to be examined carefully before taking a decision concerning the establishment of the PE of the broadcaster.

5.4.1 Recently the Apex Court has upheld the decision of the Delhi High Court in the case of *Formula One World Championship Limited vs. CIT,* (80 (2017 Taxmannn.com 347 (SC), treating the 'Buddh International Circuit' as a 'permanent establishment' (PE) of 'Formula One World Championship Limited' (FOWC) in terms of Article 5 of the IndiaUK Tax Treaty. This is an important ruling laying down the law in relation to fixed place of business PE as the Court has referred to many major commentaries on the interpretation of a "fixed place of business". In case of foreign companies engaged in content generation and operation in India for short duration, such analysis is a must as considerations are generally quite high. The assessing officers should know the logical reasoning and analysis done by the Supreme Court in arriving at its decision. The salient features of this judgment are briefly given below:

a. The SC had relied on various illustrative examples of fixed place PE as elucidated in the commentaries on Double Taxation Conventions by Philip Baker Q C, Klaus Vogel and the OECD. The SC also placed reliance on the interpretation of fixed place PE in various judicial decisions in India as well as in other jurisdictions.

b. The Buddh International Circuit was a fixed place, from where the Indian Grand Prix was conducted including all other activities in relation thereto as set out in various agreements and this undoubtedly constituted an economic and business activity of FOWC.

c. To answer the question of whether the circuit was put at the disposal of FOWC, the Court examined the manner in which commercial rights held by FOWC and its affiliates were exploited. To this end, the Court opined that the various agreements executed between Federation Internationale de I' Automobile (FIA), FOWC, Jaypee and FOWC's affiliates could not be looked at in isolation from one another. A conjoint reading thereof was necessary to bring out the real transaction between the parties and to capture the real essence of FOWC's role and to determine who had real and dominant control over the event.

d. On a perusal of various agreements, the Court observed that by virtue of the Concorde Agreement of 2009, FOWC was authorized to exploit the commercial rights in relation to the "F1 Business" directly or indirectly only through its affiliates, where "F1 Business" was defined to mean exploitation of various rights, including media rights, hospitality rights, title sponsorship etc. Under the 'Race Promotion Contract' entered into by FOWC with Jaypee, the right to host, stage and promote the Formula One Grand Prix of India was given by FOWC to Jaypee for a consideration. On the same day, another agreement was signed between Jaypee and three affiliates of FOWC, whereby Jaypee gave back (i) Circuit rights, mainly media and title sponsorship; (ii) Paddock rights; and (iii) Rights to services such as generation of television feed, licensing and supervision of other parties at the event, travel, transport and data support to the three affiliates.

e. The aforementioned rights were critical to hosting the Grand Prix in India. The success of the event depended not only on the track and participation by teams, but was also guaranteed by services aimed at ensuring maximum public viewership such as paddock seating, media advertising, television broadcasting etc, all of which were outsourced to affiliates of FOWC. Revenues generated there from solely accrued to FOWC's associates. Such an arrangement clearly demonstrated that the entire event had been taken over and controlled by FOWC and its affiliates.

f. The SC rejected the argument that the duration for which the circuit and the associated infrastructure at the disposal of FOWC was too short. The fact was that the race was to be held for only three days in a year, i.e. the business was to be conducted only for three days. Since for all the three days the entire control was with FOWC, this duration was considered sufficient to constitute a fixed place PE.

g. The Court observed that even the physical control of the circuit was with FOWC and its affiliates from the inception, i.e. right from inclusion of the event in the F1 calendar till the conclusion of the event. The Buddh International Circuit was under the control and at the disposal of FOWC through which it conducted its business as the commercial rights holder of the F1 Championship.

5.5 Taking a clue from OECD guidelines on digital economy, India has recently introduced two new levies/ taxes. First is a 6 per cent equalization levy on any payments made by an Indian resident to a non-resident toward online advertisements i.e. on gross India advertising revenue earned by foreign digital platforms or service providers. The liability on withholding equalization and filing return has been cast on the Indian resident making payments to such a non-resident recipient.

5.5.1 Secondly the government has introduced the concept of significant economic presence (SEP) under the domestic tax laws, keeping in view the BEPS action plan of the Organisation for Economic Cooperation and Development (OECD). The SEP concept gives importance to the situs of buyer rather than of the seller. The SEP can be triggered based on the revenue generated from India and on account of users from India, without the companies having any physical presence in India.

5.5.2 Another change in the domestic tax law is the widening of definition of business connection to include business activities carried on by non-residents through agents in India who habitually plays the principal role leading to conclusion of contracts. This would bring activities which are closely and intimately connected to the conclusion of contracts, *viz.*, negotiation, marketing, information gathering etc. under tax purview. The role of the Indian entities that carry out marketing/technical support service for foreign entities need to be examined in this context.

5.6 The Subscription revenues of FTC are typically collected by distributors in India, and subsequently remitted to FTC. Such payments towards grant of distribution rights have been held to be for use of copyright and are subject to tax in India as royalty rather than business income (as held by the Tribunal in several cases).

5.6.1 The CBDT Circular No.6/2001 dated 05.03.2001 mandates that the total income of FTCs from advertisements, hitherto computed on a presumptive basis, shall now be determined by the Assessing officers in accordance with the other provisions of the Incometax Act, 1961 in relation to the assessment year 20.02.2003 and subsequent assessment years. In case, accounts for Indian operations are not available, the provisions of rule 10 of the Incometax Rules, 1962 may be invoked. Where an FTC is a resident of a country with whom India has a Double Taxation Avoidance Agreement (DTAA), its business income (including receipts from advertisement) can be taxed only if it has a Permanent Establishment in India. Therefore, the taxability of an FTC in this regard shall be determined on the facts and circumstances of each case. Taxation of FTCs who are residents of countries with whom India does not have a DTAA, shall be governed by the provisions of Section 5, read with Section 9 of the Incometax Act, 1961. The Circular also mentions that other incomes like subscription charges receivable from cable operators in respect of pay channels and income from the sale or lease of decoders, etc., shall be taxed in the same manner.

5.7 The sharing of subscription and advertising revenue between the FTC and India subsidiary (or associated enterprise) is also subject to Transfer Pricing analysis to ensure that the Indian party retains revenue commensurate with their functions performed, assets used and risks undertaken.

6. ANALYSIS OF RECEIPT SIDE OF TV CHANNELS

6.1 Subscription Income: The Subscription income represents fees billed to Cable Operators and Direct to Home ('DTH') Service Providers towards paychannels operated by the television channels. In the analog era, this amount was often determined merely on an estimate based on the number of subscription points to which the service was provided. The incomplete digitization of the broadcasting systems offered a scope of understating of the subscription income

by the television channels, particularly the component received from the cable operators. As against this, the subscription income from DTH customers has little scope of understating.

6.1.1 In the case of foreign telecasting companies the characterisation of subscription revenues is invariably disputed as to whether it is in the nature of business income or royalty. While foreign broadcasters claim such revenues are business income, and therefore not subject to tax in India, the Indian tax authorities hold such income as royalty and subject to tax on a gross basis. The question here is whether payments for the use of satellite transponders by broadcasting companies, constitutes 'royalty' under Section 9(1) (iv) of the Income-tax Act, 1961 or not. There have been differing viewpoints on this issue. For instance, in the case of *ADIT vs. Asia Satellite Telecommunication Co. Ltd.* (2010) 191 Taxmannn 177 (Delhi), the Delhi High Court held that no income accrued in India from the use of satellite outside India to beam signals for viewing in India even if the bulk of revenue arises from India. In the case of *ADIT vs. Neo Sports Broadcast Pvt. Ltd.* (2011)15 Taxmannn.com 175 (Mumbai), the ITAT held that even payment for licenses for live broadcast of cricket matches was not 'royalty' under the Act. (However, it appears that in this case the broadcast mechanism of live matches was not properly presented before the ITAT). The position has now changed pursuant to the amendment to the Act vide Explanation 6 and accordingly, the Chennai ITAT in the case of Shri *Balaji Communications* (2013) 30 Taxmannn.com 100 (Chennaitrib.) has held that payment for satellite broadcasting rights constituted royalty under Section 9(1)(iv) of the Act and should be taxed accordingly.

6.1.2 Another issue is that even though the Act has been retrospectively amended to specifically include satellite transmissions within the purview of Royalty under Section 9, how does it affect the position under the DTAAs as the related provisions of such treaties mostly remain unaffected by such amendment. The assessing officers should note that where certain terms are not defined in the DTAA, the meaning of such terms can be taken from the relevant taxation Act. At times, the DTAAs have such an enabling Clause also.

6.2 Advertisement Income: Advertising income is recognised in the books of the television channels when the related advertisements are telecast in accordance with contractual obligations. Typically, three parties are involved in this advertising process, namely the broadcaster/television channel, advertising agency, and the advertiser. Payments are made by the advertiser to the advertising agency and by the advertising agency to the broadcaster.

6.2.1 The advertising agencies market the advertisement space and collect payment for the same from the advertisers. Then they pass on these payments to the broadcasters/ TV Channels after retaining their fee/ commission as well as their cost of content development, if any. In other words, the broadcasters/ TV Channels pay fee or commission to the advertising agencies though the amount is usually retained by the advertising agencies from the advertisement payments collected by them from the advertisers. The question of applicability of TDS provisions on payments which are deemed to have been made by television channels to their advertising agencies for procuring advertisements is a matter of dispute. The issue is whether the fees retained by advertising companies from television companies for booking advertisements (typically 15% of the billing) is "commission" or "discount". One view is that since the relationship between advertising agency and television company is on a principaltoprincipal basis, such payments are in the nature of trade discount and not commission, hence, the same is out of the purview of Section 194H of the Act. The alternate view is that since the television companies first credit the gross receipt in their books and then offers only net receipts for taxation after deducting a certain percentage of gross receipts, the difference between gross figure and net receipts, effectively

constitutes commission payment from television channels to advertising agencies. This would appear to make it liable for tax deduction at source within the meaning of Section 194H of the Act. The Circular No. 5/2016 dated 29.02.2016 of the Board has clarified that no TDS is attracted on payments made by television channels to the advertising agency for procuring of or canvassing for advertisements. However, on the facts of that case, the Hon'ble Supreme Court in *Director, Prasar Bharati vs. DIT*, Thiruvananthapuram [2012] reported in 92 Taxmannn.com 11, has held that payment made by Prasar Bharati to various accredited advertising agencies attracted TDS u/s. 194H of the Act. The decision of the Supreme Court hinged on the nature of agreement between Prasar Bharti and the advertising agencies. The Supreme Court had noted that in Prasar Bharti case the advertising agency was appointed as the agent of the Prasar Bharti. The facts also revealed that the agreement mentioned that the advertisement material should conform to the policies of Doordarshan which is nothing but a Government agency and which cannot telecast all what is desired to be telecast by advertising agencies. Doordarshan was bound by advertisement contract canvassed by advertising agencies and it was their duty to telecast advertisement material in terms of the contract which the agency signs with the customer. It was held that the transaction between Prasar Bharti and the advertising agencies is a pure agency arrangement because one acts for the other and the act of the agent binds the respondent in their capacity as Principal of the agent. It is pertinent to note that commission or brokerage defined under explanation (i) to Section 194H has a wide meaning and it covers any payment received or receivable directly or indirectly by a person acting on behalf of another person for services rendered. The relationship of principal and agent was fully established since the advertising agency was appointed as agent by written agreement and there was also a specific Clause that tax shall be deductible at source on payment of trade discount. In the said circumstances, the Court upheld the view that Section 194H of the Income-tax Act was applicable.

6.2.2 Many a times the channel/broadcaster is located outside India and to obtain advertisement from India it appoints an advertising agent for the Indian territory. The advertising agent in India receives commission at a fixed percentage of the advertisement revenues which is usually in the range of 10% to 15%. At times it is observed that these agents have been given the authority to conclude contracts on behalf of the channels/broadcasters. In such cases, it can be held that the channel/ broadcaster is operating in India through the Permanent Establishment of the local advertisement agent and, therefore, the profits attributable to the channels/ broadcasters from the operations in India are liable to be taxed in India through the advertising agent, being its PE.

6.3 Similarly payments made to the broadcasters for advertisements at billboards displayed in stadium during telecast of sports activities such as cricket matches and display of logos on the dresses and equipments of sportsmen are also in dispute on account of applicable TDS rates whether as 'technical services', 'rent' or 'work contract'. The AO is required to examine and verify the individual contracts carefully to arrive at a conclusion in respect of the same.

7. ANALYSIS OF EXPENSE SIDE OF TV CHANNELS

7.1 Invariably the major expenses booked by the television channels are:

a. Program cost

b. Technical Cost: These include Channel Placement Fees, Uplinking fees, Transponder hire charges, Dubbing expenses, Subtitling expenses etc.

c. Marketing, distribution and promotion expenses

8. Program Cost: The program cost involves two types of expenses:

a. **Content Production Cost:** In such a case the television channels make an agreement with an outside Production House for procuring content. The Production houses do so and raises invoices on a perepisode basis. The copyrights of the program mostly vest with Production House. There are other variations also e.g. a case where the television company gives specifications to the Production House and asks it to make the content as per its specifications. There could also be a case where the Production House suomoto shoot some pilot episodes and present it to television channel, who then approves it and asks the Production Houses to deliver the remaining content as per the terms of the agreement. In other cases, the television companies may themselves produce the content and in such a case the copyright of the program so produced vests with the television channel.

b. **Outright Purchase of Readymade Content:** In this case, the television channels make a lump sum payment to outside producers for purchase of content which is then exploited by the television channel for certain period. In case of purchase of movie rights, the television companies follow this model.

8.1 Tax/ TDS Issues in Payment of Content Production Charges: The CBDT has issued another Circular No.4/2016 dated 29.02.2016 on TDS on payments by broadcasters/television channels to production houses for production of content or programme for telecasting. It has been clarified therein that in a situation where the content/programme is produced as per the specifications provided by the broadcaster/ telecaster and the copyright of the content/ programme also gets transferred to the telecaster/ broadcaster, such contract would be covered by the definition of the term 'work' in Section 194C of the Act and, therefore, it would be subject to TDS under Section 194C rather than under Section 194J as payment for 'professional or technical services'.

8.2 Tax/ TDS Issues in Payment for Outright Purchase of Content: In the CBDT Circular No.4/2016 dated 29.02.2016 it has been further clarified that in a case where the telecaster/broadcaster acquires only the telecasting/broadcasting rights of the content already produced by the production house, there is no contract for 'carrying out any work', as required u/s 194C. However, such payments may be liable for TDS under other Sections under Chapter XVIIC of the Act.

8.3 It is also noted that the broadcasting rights of a movie are usually bought by the television channels by making a lumpsum payment. The broadcasters claim such cost as a revenue expenditure deductible in the first year. However, some Assessing Officers have treated such content cost as an intangible asset entitled to depreciation at the rate of 25%.

9. Technical Cost: There are four major components of the technical cost:

a. Channel Placement Fee

b. Transponder hire charges or uplinking charges.

c. Subtitling Charges

d. Dubbing Expenses

9.1 Channel Placement Fees: As per the regulations and guidelines issued by the TRAI, every broadcaster is required to pay a certain carriage fee and placement fee to the distributor of the particular TV channel. Channel placement fee is paid to a distributor of TV channels for setup and placement of the channels of the broadcaster visavis channels of other broadcasters on the distribution platform owned and operated by such distributor of TV channels. It is also a fee paid by the broadcasters towards

the placement of such channels on a particular frequency or bandwidth in a manner in which it would ensure more viewership for the channel. The broadcaster in India pay channel or band placement fees to multi system operators (MSOs) or the cable operators for placing their channel on a preferred frequency or band to augment viewership of the channel. Many Assessing Officers have taken the stand that the Channel Placement Fees paid for placing a particular channel on a particular frequency is in the nature of 'royalty' as defined in Section 9(1)(vi) of the Act and TDS Section 194J would be applicable. Another view is that TDS ought to have been made under Section194H as the payment is like a commission for facilitating business. In some other cases, it has been held that by agreeing to place the channel on a preferred band, the cable operator did not render any service involving any principalagent relationship and the carriage fees is only in nature of carrying out "work" of broadcasting and telecasting by ensuring that a particular channel was assigned a particular frequency. The above issues may be considered appropriately as per the facts of each case and the applicable law. The correct TDS provision applicable in a particular case would depend on ascertaining the precise purpose of payment. It may also be seen whether the TV channel has approached the DTH/Cable operators for telecasting its programs on its own behalf, or, whether right to use in programs are transferred by TV channel to DTH/Cable operators for value. There are a number of judicial decisions available on these aspects.

9.2 Transponder Hire Charges/ Uplinking Charges: The Broadcasting companies pay transponder charges to satellite companies for transmission of their TV signals. To overcome certain adverse decisions of the Courts, this activity has been specifically brought under the definition of the term 'royalty' by the Finance Act, 2012 w.r.e.f. 161976 and is now covered under the definition of "process" in Explanation 6 to Section 9(1)(vi) of the Income-tax Act, 1961. Thus, the payments made for use of such process are in the nature of "royalty" coming within the meaning of Clause (*iii*) of *Explanation 2* to Section 9(1)(*vi*) of the Act as also within the meaning of Clause (*vi*) of *Explanation 2* of Section 9(1)(*vi*) of the Act. This view has been upheld by the ITAT, Mumbai Bench in the case of *Viacom 18 Media (P.) Ltd vs. ADIT* (International Taxation) 2(2), Mumbai [2014] 66 SOT 18 (Mumbai Trib.). In this case the ITAT has held that the transponder fees payable by the appellant to the American Company are in the nature of 'royalty' as per provisions of the Income-tax Act, 1961 and also the IndiaUSA Tax Treaty and had upheld the order of the Assessing Officer in directing the Appellant to withhold tax from such payments under Section 195 of the Act. The ITAT has observed that the term process, industrial, commercial or scientific equipment are not defined in the DTAA. Therefore, the meaning of such terms under the Income-tax Act, 1961 shall apply by virtue of Article 3(2) of IndiaUS DTAA.

9.2.1 However, in certain cases e.g. in the case of *Independent News Service (P.) Ltd vs. ITO* [2018] 90 Taxmannn.com 163 (Delhi Trib.) the ITAT, Delhi has ruled that the payment made by assessee to a company situated in USA towards hiring charges for transponder is not taxable in India. The reason given was that the amendment of Clause (vi) of subSection (1) of Section 9 by the Finance Act, 2012, with effect from 161976 is not applicable to DTAA between India and USA. Hence, although the said payment is taxable under Indian Income-tax Act, 1961, the relief is available to the assessee under DTAA between India and USA.

9.2.2 The relevant rulings in the matter need to be considered in the proper perspective by the assessing officers. One aspect which needs to be examined in such cases is whether the uplinking is being done from Indian territory or from outside. Needless to say, that if the transponder fees are paid to any domestic entity, the same will partake the nature of royalty payments and TDS needs to be made on such payments.

10. Subtitling Charges: Subtitles are textual versions of the dialogues in the films and television programmes which are normally displayed at the bottom of the screen. Here also one stand is that this will be covered by Section 194J and not by Section 194C. The Courts are, however, of the view that subtitling would be covered by the definition of "work" in Clause (iv) of explanation to Section 194C.This issue may be examined by the assessing officers as per the facts of the case before them and the applicable law.

11. Dubbing Expenses: The assessees usually categorise the dubbing expenses as in the nature of a work contract and deduct tax under Section 194C of the Act. However, some Assessing Officers have taken the view that the dubbing is work performed by technically competent person with expertise and, therefore, such payments were in the nature of 'fees for technical/professional service warranting the application of Section 194J. There are some decisions wherein a view has been taken that the activity of dubbing is process in the production activity and, therefore, it was in the nature of 'work' falling under Section 194C of the Act. However recently the Bombay High Court has admitted the question of law raised by the Revenue on this issue in the case of *CIT TDS2, Mumbai vs. Zee Entertainment Enterprises Ltd* [2018] 92 Taxmannn.com 30 (Bombay) and the matter is still not reached any finality.

12. TAXATION ISSUES IN CASE OF TV PROGRAM PRODUCER

A programme producer can have different kinds of arrangements with a TV channel. The producer can take on hire a time slot on a channel to run his program and his main income would come from advertisements and endorsements. Income can also come from sale of copyright either for a lump sum and/or royalty over a period of time or combination of the two. A TV serial may also be sold off to the channel. Generally, this would be done in instalments on a per episode basis which may be sold with minimum number being committed initially and, thereafter, their numbers being mutually extended. The contract price would be determined for initial number and per extensions price may or may not be predetermined. Extensions would be based on acceptance level by the viewers of the episodes already telecast. The price of extensions can vary with reference to the TRP of the preceding episodes.

13. METHOD FOR ACCOUNTING BY TV PROGRAM PRODUCER

13.1 Generally, accounting of costs and revenue should be done episodewise. The expenses which are directly related to the episode should be assigned to a particular episode only. The other Pre-Production costs, setup costs and common expenses can be allocated on an equitable and logical basis. The periodical expenses may be debited to the *P & L* A/c. Subject to terms of the contract, the invoice is raised on the delivery of the episode and on its approval by the channel. Therefore, the income needs to be accounted for upon such approval. The responsibility of the producer ends upon approval of the episode and even if the episode does not get telecast by the channels, the producer would not be concerned since the episodes have been sold by him to the channel. However, in cases where the producer has bought time on the channel, any episode produced but not telecast would normally lead to losses.

13.2 The accounting of the episodes in progress is also a debatable issue. At the end of the year, it has to be determined how much cost pertains to each episode which were either not telecast or delivered. This issue gains significance because except for direct costs, like the payments to technicians or artistes which are made per episode, it may be difficult to allocate common costs in respect to episodes not telecast. This valuation of closing stock is a complex issue in case of mega serials because there are huge Pre-Production and setup costs. Such serials break even only after the telecast of many episodes because the revenue stream flows very slowly with the rise in TRP. Hence, there is lower income from the telecast of the

initial episodes while the costs of initial episodes may be disproportionately high because of Pre-Production and setup costs. Further, the initial episodes are required to be of a good quality to establish itself on the TRP charts. Thus, a producer may go for a lower expected revenue and WIP and finished goods would be accounted for an amount which perhaps be lower than the cost. The Assessing officer needs to call for the details to ascertain how the Net Realizable Value (NRV) of the closing stock was arrived at. If no tenable basis is found for booking the stock at a value below the cost, the Assessing Officer may consider the closing stock at the cost value.

13.3 However, some contracts with the channel companies may provide that on telecast of each episode, only a limited amount will be released and the balance will be withheld, to be released only on agreed episodes getting produced and delivered. In such contracts, it may be canvassed that the right to receive the withheld portion arises only on successful completion of minimum agreed episodes. This type of recognition of revenue or its deferral would ultimately depend upon the certainty of receivables as per facts.

13.4 The serial/ program producer will be entitled to Recognise income on approval of each episode and raising of the invoice by it. There have been instances where the producer had received certain receipts after the delivery of the episodes which are shown as 'advance' in its books on the ground that the episode was not telecast. These have been treated as taxable receipt by some Assessing Officers. The stand taken by the Producers is that they recognise revenue on the basis of telecast date and not on the basis of date of delivery to the broadcaster. This maybe so if their agreement with satellite channels provide that the programme can be rejected by the latter. It does happen a number of times that the episodes are sent back to the producer for making corrections in technical aspects or content. It is therefore, necessary for the Assessing Officer to examine carefully the governing agreement between the producer and the broadcaster to check whether the rejection Clause of the program is present in the agreement or not. In the absence of such conditions, the value of episodes that have been delivered but not yet telecast, should ordinarily be recognised as revenue.

13.5 A possible tax angle here would be when the serial/ program is in its early stage with low levels of viewership and consequently low advertisement income. As the TRP increases, the advertisement income would increase. Therefore, in respect of initial episodes, the income would be comparatively lower than the expenditure and initial episodes may result into losses also.

13.6 In some cases, it has been noticed that the Production houses are debiting the entire cost to its books of account once the program gets telecast on the television channel. However, it ought to be kept in mind that even after the telecast of the programme, there may be certain valuable rights still left to be exploited, like that of repeat telecast, sale of overseas rights, sale of copyrights, etc. Even if the trade practice is to claim the entire episode cost in the year of telecast the Assessing Officer needs to appreciate that the telecast of the episode is not the end of its useful life. Hence, the Assessing Officer needs to scrutinize the subsequent years' Profit & Loss account also and if he finds that the assessee has credited some income by exploitation of rights of program already telecast, he will then be justified to withhold a part of estimated expense on the programs getting telecast during the year so that the same can be "matched" with earnings from such avenues. This issue may be examined in the light of judicial precedents [Refer Taparia Tools, (2015) 372 ITR 605 (Supreme Court)].

14. OTHER CRUCIAL ISSUES RELATING TO TAXATION

14.1 Benefit of carry forward of losses on amalgamation: As per Section 72A, the industrial undertakings which are eligible for benefit of carry forward and set off of losses in

case of amalgamations include undertakings providing telecommunication services, but they do not include undertakings in the Media & Entertainment sector.

14.2 Further, the issue of applicability of TDS on discount given to distributors on sale of set top boxes/recharge coupon vouchers for the Direct to Home (DTH) industry is still not settled. Such discount is taken as in the nature of commission and hence subject to TDS.

14.3 With increasing number of leaguebased events held in India/abroad, the issues of taxation of sports associations and teams/ sportspersons have gained importance. Their media/broadcast rights include the right to carry and display the sports events on traditional and digital media. The major issues are TDS on acquisition of live telecasting rights, payments made to foreign sports body, prize money paid to foreign teams, payment towards sponsorship/ advertising revenues, etc. The assessing officers should be careful while dealing with such issues. One of the media houses had recently won the global media rights for a cricketing event to be held from 20182022 with a consolidated bid in excess of Rs.16,347.50 crores. The media house/ broadcasters would earn royalty from selling exclusive footage and other rights to others. The liability to deduct tax at source in such a case should be carefully ascertained.

14.4 Cloud Broadcasting: Nowadays broadcasters and media houses worldwide are launching their own applications or portals for direct delivery of content to consumers using cloud. In India, Emerald India, the panAsian platform established by global investment firm KKR & Co. has acquired a minority stake in 'Amagi', which itself is a world leader in the area of targeted television advertising and cloudbased TV broadcast infrastructure. The Bollywood film and music channel B4U sits on an Amagi platform in London where its scheduling is done, while its content is pushed from Mumbai. The channel beams into India, the UK, Canada and Singapore even as it is monitored in Bengaluru, where Amagi has a broadcast innovation lab.

14.4.1 The Cloud broadcasting generally operates as Software as a Service (SaaS) model where the broadcaster gets access to remote software application via internet. The income of cloud broadcasters from subscribers and payment to cloud service providers may be examined from the point of view of Royalty after considering the relevant facts like control/access over the cloud server hosting the platform, software, etc. or the nature of access given to platform or software licensed/transferred, etc. Similarly, payment for use of specific data storage space on remote server for storage of content may require to be examined from the point of view of equipment royalty depending on the degree of control with broadcaster, transfer of possession of server, etc. The assessing officers should also examine the issues relating to Permanent Establishment (PE) of the cloud service provider depending on the location of server, degree of control, employees visiting India, etc. Cloud broadcasters delivering online content to the users in India may trigger 'significant economic presence' under the domestic tax law based on the *revenue generated* and *viewers/users* from India.

14.4.2 The TV channel broadcasters are likely to move to cloudbased business model as it promises to provide substantial benefits in terms of the following:

a. Content flow from content creators to broadcasters,

b. Post-Production workflows,

c. Content delivery to distribution platforms, and

d. Direct to consumer distribution model.

14.4.3 The cloudbased services can enable the broadcasters to commission content from anywhere on the globe and once the content is ready, the same can be made easily accessible to the customers. It enables a large volume of data to be easily sent to Post-Production locations

and brought back to delivery locations. It also enables the TV networks to deliver regionspecific content to various parts in the same footprint area. With the increase in bandwidth for home Internet connections and the rapid proliferation of mobile devices, the television channels as well as the content owners can now reach their customers directly through Overthetop (OTT) delivery models. The content owners and TV networks can now post their content on the cloud and leveraged OTT infrastructure providers to create linear, ondemand video catalogues and distribute content through their own branded apps and web portals. All these issues would present complexities in tax administration and the assessing officer is required to minutely investigate the workflow pattern as well as the business models before applying the law.

15. RADIO INDUSTRY

There are certain specific issues in radio industry which are dealt hereunder:

a. **License Fee:** Any company willing to operate a FM radio channel has to pay onetime entry license fee to the Government for operation of channel for a period of 10 years. Apart from this, the radio operator is also required to pay an annual license fee linked to the gross revenue earnings of the assessee for that particular year. There have been controversies as to whether the license fee is a capital or revenue expenditure. The correctness of the tax treatment meted by the assessee should be examined. It is held by some that onetime license fee is paid for the entire licencing period and hence it needs to be capitalized as an Intangible Asset. However, regarding the turnoverlinked annual license fee, a view is that it may be difficult to treat this as capital in nature, unless the agreement terms itself indicates an enduring benefit accruing to the assessee.

b. **Depreciation on the Equipment:** In the case of *Malayala Manorama Co. Ltd vs. ACIT* (2013) 40 Taxmannn. com 380 (CochinTrib), the license for commencement of FM radio broadcasting was granted by the Government to the assessee in the year succeeding the year in which the equipment was purchased by the assessee. The assessee claimed depreciation for the earlier year also. The same was disallowed for the reason that the equipment was not put to use. The stand of the AO was upheld by the ITAT. Another issue in this case was that the assessee had claimed additional depreciation on the radio equipment by stating that additional depreciation was "assessee specific" and not "asset specific". As it was in the business of publishing newspapers/ magazines, the assessee claimed that it should be considered as being engaged in the manufacture or production of article or thing and, accordingly, the additional depreciation should be allowed on FM radio equipment. On appeal, the Appellate Tribunal held that the FM radio operations do not result in manufacture or production of any article or thing and the additional depreciation cannot be granted on the purchase of FM radio equipment. However, on the facts of the case before it, the Delhi High Court in the case of *CIT vs. Radio Today Broadcasting Ltd* [2016] 382 ITR 42 (Delhi) has held that the radio programmes produced by the Assessee amount to a 'thing', if not an 'article' and additional depreciation was allowed to that assessee. However, the Court in its order has noted that the Revenue has not taken the stand that the activity of 'broadcasting' does not amounts to 'business of manufacture or production' and, therefore, the same was not an issue in this case.

CHAPTER

9

Event Management and Entertainment Industry

A. EVENT MANAGEMENT BUSINESS

1. OVERVIEW

1.1 Organising events have always been an integral part of the social fabric of the human beings and have always played a very important role in connecting people and communities. Prior to advent of modern societies, marriages & social functions as well as religious functions were organised by the communities with active participation of all the members of the society. However, in the modern days organising events has become a challenge because of lack of community life and demanding city life resulting in paucity of time. This precisely is the cause for advent of event management industry which came as solution for organising events without support of community.

1.2 In the 20th century, the growth of event planning as a legitimate profession took off with the investment of welltodo families who required the services of planners to handle the preparations for their wedding, parties and receptions. The complexity of events, both personal and corporate, began to require a professional hand to help organize the various components, ranging from sending invitations to managing caterers. With changing world, even the nature and scale of events have also changed and expanded beyond conceivable limits.

1.3 As technology advances so do the manner in which people plan and host events. Earlier posters, pamphlets and wordofmouth were popular ways to advertise events. The advent of internet allowed the people to search for events utilizing websites dedicated to the events. Users can type in their location and find hundreds of events that they may not have been even aware of. The introduction of mobile phones and the internet had an enormous impact on event planning. With the use of these electronics gazettes, communication can happen at any time of the day and from anywhere in the world. A person can create, find, register and document an event by using one small portable device. The most considerable change in technology has afforded to an individual or organisation is to have more control over event management. Software and websites allow people to construct advertisements for events with userfriendly formats that are slick and professional. Ticket

sales and registrations are organized on spot. In the fastpaced world of the internet, time is limited and valuable. Event management websites and apps save people time while providing easy options for creating events.

2. Categories: In order to understand the functioning of event managing process, events could be categorised broadly in following three categories:

a. Social

b. Corporate

c. Commercial

2.1 Social: Marriages are still the most important function in social category of events. Receptions, Anniversaries, Birthday parties, events to celebrate educational or business success of a family member are other such events in this category. Although, some of the marriages and receptions are held at very grand scale, the social events are relatively the smallest segment of event managing in terms of scale and volume.

2.2 Corporate: Organising corporate events are popular for the reason that they are effective at achieving the desired result of the organisers. Whether hosting a conference or a golf tournament, companies use these events to bring people together in a new way, developing interpersonal relationships that couldn't exist inside the structured environment of the office. Such events are bigger than most of the social events in terms of scale and magnitude. The Corporate events could further be broadly categorised as below:

a. **Seminars and Conferences**: Organisations plan and hold these meetings with targeted audiences and provide them with relevant information. Seminars are usually shorter events, lasting a couple hours to a few workdays, while Conferences typically have multiple sessions.

b. **Trade Shows**: Organisations attend trade shows as a lead generation activity. They may also choose to host or sponsor a trade show to reinforce their image as an industry leader among those who attend. Event planning for trade shows involves negotiating sponsorship rates for booth space, advertising, promotion, and speaking opportunities where company leadership can speak. Trade shows are held in large spaces, showcasing the products and services of often hundreds of vendors.

c. **Executive Retreats and Incentive Programs**: This is where the big bucks are spent on a perperson basis. Business development and organisational planning are typically the topics of the agenda, but equal weight is given to enjoyable activities as part of the original incentive and reward. Executive retreats and incentive trips typically last between three and five days and require attention to site selection, lodging, transportation, catering, business meetings, golfing and other activities.

d. **Golf Events**: A favourite event of almost every organisation is an annual golf outing. Relationship management is the primary objective, and teams are often constructed for that purpose. The idea, like the executive retreat, is to give people in the organisation a venue where they will be able to build relationships in a relaxed environment. There is a saying that "deals are sealed on the green."

e. **Appreciation Events**: These programs allow an event host to spend informal time with its guests in a nontraditional environment, giving both parties an opportunity to build rapport and learn more about mutual business priorities. Appreciation events can range from programs geared toward employee appreciation to those for showing client

appreciation, both of which have become a staple in corporate America.

2.3 Commercial: This is the category which reflects the biggest of the events in terms of scale and magnitude such as organising sporting events such as IPL and other leagues of multiple sports, Asian Games, Commonwealth Games, TV reality shows, other game shows etc. In fact lot of entertainment industry's recent success can be attributed to the trend of reality television. As per an Industry estimate, almost 40 per cent of a TV channel's content is nonfiction. Reality shows, dancing and singing competitions all fall under the domain of event management. It is believed that the key growth drivers for this growth are digital activation, sports leagues, rural expansion and government initiatives followed by personal events, product launches, and expansion of mini metros.

2.3.1 The Events & Activation industry is growing at a fast pace and is expected to further grow exponentially due to its ability to adapt and grow with innovative technology and with focus on newer avenues such as sports leagues, rural expansion, digital activations, increased Government marketing initiatives etc. As per industry estimate, the digital events and activations garnered an 8% revenue share in 2016–2017 as the industry has been estimated to be growing at a compounded annual growth rate (CAGR) of 15% over the last five years, which is expected to increase to 16% in the next few years. A report from global accounting and advisory firm E&Y predicts that the industry will surpass the Rs. 10,000 crores mark by 2021.

2.3.2 In terms of clientele, the corporate world provides highest business to the event firms. Corporate represent 75% of the total clients for the firms, of which 19% were MNCs and 36% were Indian. The government and public sector were the second largest providers, at 11%, while High Networth Individuals comprised 9%. Associations constituted the remaining 5% of the clientele.

3. Functions: The main functions of a typical **Event Management** entity are explained as below:

3.1 Planning: Planning plays an important role in the preparation for any event. The time frame involved in decision making being limited, planning assumes that much more importance as a function. It begins with putting all that is required to manage the event on paper including budget for expenditure, understanding the client profile, the brief for the event, the target audience & number expected and preparation of the event cash flow statement. It also warrants that the overall coordinator, the project manager and the sales team is given defined roles and clear assignments for smooth execution of different works. The planning function is also involved in microlevel event coordination activities such as liaison with the creative team, discussing, facilitating and arranging for the technical specification such as, sound, light, stages and sets, shortlisting artists and stand by artists. It also deals with hard practical realities such as the logistics i.e., transportation of material, travel, stay, etc. and the networking *viz.*, media plan, ad designs, banners printing, tickets invites designing and printing. Deciding soft issues such as whether the show is to be a ticketed, nonticketed, fully or partially sponsored is also part of the planning exercise.

3.1.1 In the case of a company arranging a commercial event, inflows to the event company's could basically from a combination of the revenues from sponsorships, ticket sales, commissions, event production charges, artist management fees and infrastructure and equipment rental charges. At the same time, on the outflow front, the payments could be for event production, suppliers' payments, venue hiring charges, payment to artists and performers, licensing and tax payments liabilities etc.

3.2 Organizing: Coordination of the arrangements required is divided among the team members. Event coordinators are essentially required for the organizing part for an event. Starting from contacting the artist or performers and in case of absence or dropouts, making standby arrangements is one of the most important functions of the event coordinator. After planning and creative teams have worked out the base plan, the event coordinator then goes about fixing the date, terms and conditions with the artist. This is followed by arranging and creating necessary infrastructure. Planning and coordinating with the professionals for the physical availability of the sound, lights, stage, sets and seating is followed by arranging for some softer aspects of organizing.

3.2.1 This also involves handling the publicity, which includes press meets, releases, etc. for a favourable coverage and handling of ticketing and invitations. The actual procurement of permissions and licenses from various Government departments finally becomes the coordinator's responsibility once the planning stage decides the requirements.

3.2.2 Arranging for hospitality management such as the stay, food and beverages, hostesses, etc. and contacting sponsors to ensure fulfilment of commitments from the event organizers' side to their clients are part of the organizing function. In short, organizing is making the event happen within the constraints defined by planning.

3.3 Staffing: The importance of team structure, experience, background and expertise of team members plays a crucial role in event management. It is the size and the resource availability in the events enterprise that to an extent defines the exact role of the staff members. In a big firm, there is more scope for specialized functional personnel with limited functional responsibilities, whereas, in a small firm, there is a fusion of roles depending purely on availability of time and staff. Exceptionally people friendly and situation savvy professionals are needed to man this post on the event front.

3.3.1 Events are very physical in nature. A host of skilled and unskilled volunteers and labour staff need to be guided effectively. Given the fact that events are do or die projects, i.e. are oneoff in nature, trouble shooting in and during the event, therefore, demands the most street smart and event savvy individuals.

3.4 Leading and Coordination: The overall coordinators need to be leaders with fantastic people skills. They are continually required to motivate the labour and other junior coordinators to work real hard given the physical nature of the job, the time constraints involved and the oneoff nature of the event.

3.5 Controlling: Evaluation and correction of deviations in the event plans to ensure conformity with original plans is the gist of controlling. The basic evaluation process in events involves three steps *viz.*, establishing tangible objectives and incorporating sensitivity in evaluation; measuring the Proformance before, during and after the event, and lastly correcting deviations from plans.

4. TAXATION ISSUES SPECIFIC TO THE EVENT MANAGEMENT BUSINESS

It is evident from the nature of business of the event managing industry that it involves association of multiple service providers, artists etc. and payments to them. The source of revenue, in the case of a commercial event could also be from multiple sources such as advertisement, ticketing, sponsorships etc. Basic taxation issues in such cases would be in realm of taxing the complete chargeable income and identifying the fictitious/ ineligible expenses. Some of those issues and circumstances are briefly mentioned hereunder for illustration:

4.1 Suppression of Receipts: Incidents of suppression of receipts by receiving part of the payments in cash is found mostly where the events are of smaller scale and where the organisers of events are individuals. In such cases

part of receipts as well as expenses are made in cash to 'manage' the profit to be shown in books of account. Since, most of service providers such as vehicle suppliers, florists, manpower suppliers etc. come from unorganised sectors; it becomes easier to manage the payments made to them by making part payments in cash. Similarly, payments to individual artists could have partly been made in cash to manage the expenses in such cases. Further, for most of the commercial events, part of the tickets are sold physically, payments of which are received mostly in cash. In such cases, there could be a case of suppression of cash receipts which may require verification.

4.2 Inflation of Expenses: In the case of relatively bigger events, the receipts are mostly accounted for and, therefore, there is tendency to inflate expenses to reduce taxable income. In order to organise a big event, often multiple event managers work for the main event management company in a pyramid kind of structure where the service providers are at the base of the structure. Introduction of fictitious entities in the form of secondary event managers, subcontractors and service providers could be one of the modalities to inflate expenses.

4.3 Unascertained Liabilities: The very nature of the event management business is such that it requires huge payments to multiple entities and individuals for performing different roles and tasks relating to the events. Hence, even if any particular payment is backed by a bill or voucher, it is imperative to verify whether the services have actually been provided for that particular event for which the payment has been claimed. Further, in the cases of events of recurring nature, such as those conducted every year, there could be a case of claiming expenses incurred during events of earlier years. Crossverifications with the books of account of the payee, in certain cases of payments may also be considered depending on the facts and circumstances of individual cases.

4.4 Reuse of Materials: In the business of event managing cost of materials such as those required for erecting stage, pandals, decoration etc. comprise significant component of expenditure. It has been noticed that after completion of a particular event all or most of such materials used are shown as discarded and sold as scrap. Whereas, in reality, a large component of these materials are reused in organising new events where those are shown as purchased as new and bogus bills of purchase are obtained for the same raising the cost for the new event substantially and thereby reducing the profit artificially.

4.5 Taxation Issues Relating to International Taxation: With advent of bigger events and involvement of multinational companies in the business of event managing, the challenges of taxation and issues involved there in have also become complex and multidimensional. Some of those issues are discussed herein which may be kept in mind by the AO at the time of assessment of such companies:

4.5.1 Tax Revenues from an Event in India: The primary source of revenue for an event manager from a commercial event is revenue from sale of live telecast rights (where an event is organized and recorded by an event owner) or management fee (where an event management company is commissioned to organize an event). The other sources of revenue include income from ticket sales and sponsorship fees. A resident event management company/ event owner in India is taxable in respect of its global income on net basis according to normal provisions of the Income-tax Act, 1961 (the Act). However, a non-resident event management company/ event owner will be taxable in following circumstances:

a. Where the person's income accrues or arises in India; or

b. Where the income deems to accrue or arise in India; or,

c. Where the income is received or is deemed to be received in India.

A norresident event management company/ event owner can choose to be governed by the provisions of the Act or the applicable Double Taxation Avoidance Agreement (DTAA), provided it is eligible to claim tax Treaty benefits and has the prescribed documentation in place. The AO is required to carefully consider taxability of income of the non-resident event manager in the light of applicable provisions.

4.5.2 Transaction at Arm's Length: Where an event management company/ event owner has entered specified transactions (international transaction, deemed international transaction, or a specified domestic transaction) with its related parties, as defined under the Act, such transactions are required to be at arm's length price. In this regard, the event management company/ event owner is required to maintain the prescribed documentation and undertake the prescribed filings with Revenue Authorities. The AO may be required to refer such transactions to the TPO to determine whether the claim of the assessee as to the transaction being at arm's length price is correct and redetermination of the arm's length price, if required.

4.5.3 Taxability of Revenues from Sale of Live Telecast Rights: The event owners typically own the rights to telecast a live event, which they may grant to broadcast companies. The issue that arises is whether revenues earned by non-resident event owners from grant of rights to telecast a live event in India are taxable in India. Generally, the taxpayers take a position that there is no "copyright" in the rights to telecast a live event in India and, therefore, the grant of such rights is not in the nature of "royalty". However, considering the facts of the specific event, the Revenue Authorities may consider the payment towards acquisition of rights to telecast a live event in India is in the nature of "royalty" for transfer of "copyright", and, therefore, taxable in India. In view of the same, the AO is required to examine carefully the taxability of income earned from transfer of rights to telecast a live event in India.

4.5.4 Taxability of Event Management Fee: According to the provisions of the Act, payment to a resident event management company i.e., event management fee, is considered to be in the nature of "professional fees" and is subject to withholding tax. In the case of a non-resident event management company, the event management fee may be considered to be in the nature of "business income" and in that case, such fee is taxable in India only where the event management company is considered to have a business presence in India i.e. having a PE in India. However, there could be a case where the event management fee would be taxable on gross basis in India as "fees for technical services" even where the company does not constitute a PE in India. The AO is, therefore, not only required to examine the issue of the non-resident constituting a PE in India but also that even where no PE is constituted whether the "event management fee" is taxable on gross basis in India as "fees for technical services".

5. TAXATION ISSUES RELATING TO WITHHOLDING TAX

Non-compliance with the withholding tax provisions results in additional interest liability, disallowance of expenses and penalty exposure. Moreover, where a payee, whose income is subject to withholding, does not have a PAN in India, the tax is required to be withheld at the rate specified in relevant provisions or 20% whichever is higher. Accordingly, the implications of withholding tax on some of the key payments in connection with an event are discussed as below:

5.1 Payments to Resident Event Managers: The CBDT has clarified that the services such as managerial, technical, professional or consultancy services provided by resident event

managers are in the nature of "professional services", and are subject to withholding at the rate of 10%, according to the Act or applicable Tax Treaty. The AO may examine the relevant provisions and determine the withholding taxes considering applicability of the relevant provisions of the Act or the DTAA as applicable in a particular case.

5.2 Taxability of Sponsorship Fee: An event owner receives sponsorship fee from various corporate organisations (i.e., sponsors), which use the events for promotion of their products. Sponsorship generally includes naming an event after the sponsor, displaying the sponsor's company logo or trading name, giving the sponsor exclusive or priority booking rights, complimentary tickets, sponsoring prizes or trophies for competition etc. Usually, sponsorship fee is a lump sum amount to be paid annually by the sponsors. The taxability of sponsorship income essentially depends on the facts of the case and commercial understanding of parties.

5.2.1 As regards payment of sponsorship fee to a resident event owner, the issue arises regarding applicability of withholding tax provisions in respect of royalty (for use of or right to use trademark or similar property) visàvis advertising contract, depending on the terms of the contract. Similarly, it required to be looked into whether the sponsorship fee paid to a non-resident event owner by various sponsors, in respect of an event in India, is in the nature of "royalty" and taxable in India as in such cases taxpayers take a position that the consideration from grant of sponsorship rights is not in the nature of "royalty", whereas, the Revenue Authorities usually take a contrary view on the basis that there is use of trademark or similar property involved.

5.3 Taxability of Revenues from Activations Business: Despite logistical challenges such as multicity events and varied target audience profiles, the activations business continues to grow with the prominent source of revenue arising from sponsors of the brand/ products. As regards the payment of fee to the companies undertaking activations, the issue arises regarding applicability of withholding tax provisions in respect of payment to resident contractors visàvis fees for professional or technical services to residents.

5.3.1 Since the purpose of activations is advertising or brand promotion, the taxpayers take a position that the payment is for advertising work and subject to withholding at the rate of 2%. However, there could be a case that the activations are in the nature of professional services and subject to withholding at the rate of 10%. According, the taxability of payments for activations will depend on the terms of the contract and the facts of each case supported by appropriate documentation.

B. ENTERTAINMENT INDUSTRY

6. The Indian entertainment industry is one of the fastest growing sectors in India. This has given impetus to segments like radio, music, animation & visual effects (VFX), live events and gaming industry. In volume terms, animation and VFX industry dominate the Entertainment Industry, followed by live events and online gaming segment.

7. Amusement and Theme Parks: The Indian amusement park/ theme park segment is expected to grow rapidly helped along by rising income levels, increased domestic tourism and rise in discretionary spending. One issue is the long gestation period, given the huge land cost and the high cost of the machinery. The players typically show huge losses initially, and after it breaks even after a few years, the brought forward accumulated losses get adjusted thereafter. However, from the investigation angle, the following issues need to be verified:

7.1 Suppression of Daily Sales: Almost 70% of the revenue of amusement park comes from the entry fee/ ticket sales. Although, now-a-days,

most of the big amusement parks have online booking, still most of the entry fees is collected in cash at the entrance counter. This daily cash collection, which on weekends runs into lakhs of rupees, can easily be suppressed.

7.2 Bogus Depreciation Claim: The amusement parks require a substantial investment on machineries and equipment. Most of them are imported. Their installation cost is also exorbitant. It is possible to raise invoices without actually installing them or in connivance with the suppliers, they can debit in their books an overinvoiced amount.

7.3 Capital Expenses Disguised as Repairs and Maintenance: The amusement parks require extensive maintenance of the machines and equipment. Thus, they incur heavy expenses on repair and maintenance purposes. It is, therefore, possible to divert by camouflaging some of the capital expenses through this repair and maintenance head.

8. LIVE EVENTS

The organised live events industry in India now stands at a staggering Rs. 6500 crores in 2017 from merely Rs. 2,800 crores in 201112. At the heart of this industry are music, theatre, comedy, dance shows, cartoon characters, Bollywood launches/ concerts and digital events which connect audiences through a shared digital environment.

8.1 As far as the taxation is concerned, the foremost issue for an event management company is that of compliance to TDS liability under Section 194C/ 194J on payments to artists/ performers for their services in the events.

8.2 Payments to Resident Artists Performing in India and Outside India: Provisions of the Act specifically provides that the services provided by resident artists for Proformance in India are in the nature of "professional services" as defined under the Act and are subject to withholding at the rate of 10%. An individual resident in India is taxable on his global income. The income from performance outside India could also be subject to withholding tax in respect to the country of performance. In case taxes are withheld in the foreign country, then the resident artist may claim the tax credit for taxes paid outside India against the tax liability in India subject to certain conditions.

8.3 Payments to Non-resident Artists Performing in India: Provisions of the Act cover within their ambit the taxability of income received by non-resident entertainers from performance in India, at the rate of 20% (excluding surcharge and education cess) on a gross basis and the consequential withholding tax rate would also be the same. Furthermore, a specific provision of the Act exempts non-resident entertainers from filing a tax return in India if the only income earned from India is in respect of performance in India and appropriate taxes are withheld from the said income.

8.3.1 Usually under the Tax Treaty, there is a separate Article on "Income earned by entertainers and athletes", which provides for artists/ entertainers in India. Even where the income from personal activities accrues to another person and not directly to the artists/ entertainers, the income is still taxable in India. Additionally, a non-resident artist, who has come to India in connection with shows or event in India and has earned taxable income in India, should obtain an Income-tax Clearance Certificate (ITCC) prior to departure from India. In the absence of procuring the ITCC, there may be practical difficulties for the artist while departing from India.

8.3.2 According to guideline issued by the CBDT, consideration paid to a non-resident artist to acquire the copyrights of performance in India for subsequent sale in India (as records, CDs, etc) or the consideration paid to the artist for acquiring the license for broadcast or telecast in India is taxable in India as "royalty" under

the Act as well as the applicable Tax Treaty. In some contractual arrangements, it is possible that the non-resident artist receives separate consideration for grant of "image rights" (including, but not restricted to, right to use name, images, videos, quotations, signature, likeness, personal attributes etc. of the non-resident artist). Most of the elements of "image rights" granted by the non-resident artist are likely to qualify for protection under the intellectual property law and, hence, are considered as "royalty". However, few components of "image rights" granted may not enjoy protection and the tax implications thereon will need to be evaluated based on the factual matrix. Accordingly, it is imperative to undertake a careful assessment of the "image rights" granted according to the agreement to determine withholding tax implications.

8.3.3 The AO is required to examine whether the following streams of income earned by a non-resident entertainer or sportsperson are taxable in India under the subject article of the relevant Tax Treaty:

a. Prize money received by the car/ horse owner from races.

b. Income of models from fashion shows performances.

c. Any consideration received by an entertainer or sportsperson for any personal activity, including appearance.

d. Income from reporting or commenting activities during the broadcasting of an entertainment or sports event.

In this regard, it is imperative to understand the nature of activities to be undertaken by the non-resident in India to determine the appropriate incometax implications.

9. SPORTS EVENTS

9.1 In the past decade, several global sports events have been held in India, e.g, Formula One racing, ICC Cricket World Cup, Indian Premier League (IPL) etc. Obviously, there has been an increased movement of the foreign sportspersons, their respective teams and their supporting staff in and out of India. This has led to the emergence of new issues in the sports field. Taxability of sportspersons and entertainers is covered under the tax treaties (Article 17 of the OECD Model Convention).The income from personal activities of sportsperson, *i.e.* their performance in India gets taxable in India. In the cases where performance income of such sportsperson accrues not to such sportsperson but to another person/ entity, such income also gets taxable in India. Taxability of crew should be evaluated based on nature and form of entity or individual, presence/ period of stay in India, tax treaty provisions.

9.2 The Hon'ble Supreme Court in *Formula One World Championship Ltd vs. CIT (International Taxation),* Delhi [(2017) 80 Taxmannn.com 347 has dwelt upon the principles of 'Permanent Establishment' in the context of a UK based company granting right to host and promote Formula F1 Race at racing circuit in India and held that in the given facts the aforesaid event constitutes a PE. This is an important ruling laying down the law in relation to fixed place of business PE as he Court has referred to many major commentaries on the interpretation of a "fixed place of business".

9.3 The Apex Court held that the *Buddh International Circuit* was a fixed place, from where the Indian Grand Prix was conducted including all other activities in relation thereto as set out in various agreements and this undoubtedly constituted an economic and business activity of FOWC. To answer the question of whether the circuit was put at the disposal of FOWC, the Court examined the manner in which commercial rights held by FOWC and its affiliates were exploited. To this end, the Court opined that the various agreements executed between multiple stake holders could

not be looked at in isolation from one another. A conjoint reading thereof was necessary to bring out the real transaction between the parties and to capture the real essence of FOWC's role and to determine who had real and dominant control over the event. It was further held that it is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise and that the place would be treated as 'at the disposal' of the enterprise when the enterprise has the right to use the said place and has control thereupon. The SC rejected the argument that the duration for which the circuit and the associated infrastructure at the disposal of FOWC was too short. The SC held that notwithstanding that the business was to be conducted for limited days in a year as the race was to be held for only three days in a year, since for all the three days the entire control was with FOWC, this duration was sufficient to constitute fixed place PE.

9.4 In case of foreign companies engaged in content generation and operation in India for short duration, such analysis is a must as considerations are generally quite high.

10. MUSIC INDUSTRY

10.1 Although music industry has suffered because of piracy, it is still growing satisfactorily. The exports are also growing with an increasing NRI segment. A typical music company operates its business by acquiring the music rights and, thereafter, manufacturing and selling music CD/ DVDs.

10.2 The master plate is in the nature of basic raw material. Unlike the tangible products, here the product is reproduction of sound, music etc., embedded into compact discs. This music may be acquired under outright purchase or under a contract for a certain period of time. The contract for use would not imply a transfer of the ownership of the recordings thereon.

11. FILM MUSIC

11.1 The music company also acquires music rights from film producers in respect of films under production or thereafter. Typically, a music company acquires absolute and beneficial rights, including the copyrights of the film songs and music of the original sound track. The film producer normally sells music rights for fixed sum initially and royalty based on sales over a period of time. The producers, in such case, remain the sole owner of the mechanical reproduction rights of CDs. The producers are to provide the music company the soundtrack or recorded version of music, songs and dialogue etc., before the film is released. The condition for the use of the soundtrack is that, it would be used for the mechanical reproduction only, on CDs. The producers would merely assign their recording rights in favour of the company. The company on its part is required to submit periodical statements of sale to the producers. The music company is made owner of the plate under the agreement for the limited purpose of ensuring that the producers are not allowed to provide the same to another competitor. The master plate contains the original soundtrack of the film relating to the songs and with the help of this master plate the company makes several copies of audio CDs for sale.

11.2 Accounting Principles: The majority of the revenue of the music companies consists of:

a. The sales of their recorded music, i.e. cassettes and CDs; and

b. The royalties received from licensing or sublicensing of the rights to the other music companies

11.3 Accounting for Sales: The sales are accounted for like in any other business. There are no specific provisions in the Act which apply to the Music Industry.

11.4 Accounting for Royalties: The lumpsum royalties are accounted as income on completion of the transaction while the royalty

based on turnover is accounted for based on the release of music tracks by the other company, contractual obligations and the information provided by such other companies regarding sales made. As far as expenses are concerned, there may be two types of payments. The first one is a fixed amount payment for the master plate and copyright in the music. The second is royalty which is recurring in nature, depending upon the volume of sales generated. The debate on whether the expenses would be capital (enduring benefit) or revenue in nature has to be considered as per the facts and extant law.

12. CIRCULAR NO.787 DATED 10.2.2000

comprises guidelines regarding taxation of income of artists, entertainers, sportsmen, etc., from international/ national/ local events. The Board noted that in many cases, the performers leave the country within a few hours of the show or event. It identified receipts in the nature of sponsorship money, gate money; advertisement revenue; sale of broadcasting/ telecasting rights; rent from hiring out of space, rents from caterers etc for examination. On the expenditure side expenses *prima facie* liable for tax deduction at source would include expenditure on guarantee money, prize money, rental for premises or equipment payments to labour contractor for decoration, salaries, royalties, fees for technical services, insurance premium for the event, etc. particularly in light of Section 115BBA ('Tax on non-resident sportsmen or sports associations'), Sections 194C, 194J and 194I of the Act and in case of non-residents, the applicability of Section 194E and Section 195 should be examined in light of the applicability of Double Taxation Avoidance Agreement (DTAA). The said Circular has also identified a few specific instances of receipts qualifying as income in India.

12.1 It may, therefore, be kept in mind that Section 115BBA of the Act applies equally to both sportspersons and entertainers. To conclude, for events involving the non-resident angle, the Assessing Officer will be welladvised to consider the provisions of Section 5 read with Section 9 of the Act, the liability of TDS under Section 194/ 195 of the Act and the contents of Circular No. 787 dated 10.02.2000 of the Board.

13. ACCELERATED ASSESSMENT

The Assessing Officers may also keep in mind the provisions of Section 174('Assessment of persons leaving India') and Section 174A ('Assessment of AOP/ BOI/ AJP formed for a particular event or purpose) of the Act.

14. DEDUCTION AGAINST PROFESSIONAL INCOME FROM FOREIGN SOURCES

Section 80RR of the Act provides for specified deduction to an individual resident comprising an author, playwright, artist, musician, actor or sportsman, including an athlete, where the gross total income includes any income derived by him in the exercise of his profession from the Government of a foreign State or any person not resident in India subject to conditions stipulated therein.

15. GAMING

15.1 While the tax models are still evolving, the winnings from lottery, online/ TV game shows, crossword puzzles, betting, card game etc., represents income as per Section 2(24)(ix) and is taxable under the head 'Income from Other Sources' in terms of Section 56(2)(ib) read with Section 115BB of the Act. The Assessing Officer may note that where an assessee has income under the head "other sources" by way of winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of

any form or nature, no deduction is admissible in respect of any expenditure or allowance in connection with such income under any provision of this Act in computing the income. Subject to conditions, this prohibition does not apply to an assessee being the owner of horses.

15.2 Further, if the prize money exceeds Rs. 10,000/, then the event owner, person disbursing is obliged to **deduct tax at source** under Section 194B of the Act at the time of payment. Where the winnings are wholly in kind, or partly in cash and partly in kind but the part in cash is not sufficient to meet the liability of deduction of tax in respect of whole of the winnings, the person responsible for paying has to ensure that tax has been paid in respect of the winnings before releasing the winnings. In case of winnings from horse races, TDS will be applicable if the amount exceeds Rs. 10,000/ as per Section 194BB read with Section 206A of the Act.

CHAPTER

10

Advertisement Industry

1. INTRODUCTION

Advertising is the art of creating awareness as well as retaining awareness about a product or service and is usually an essential part of marketing strategy. Besides the traditional forms of advertising, the present age is witnessing introduction of various new and unique advertisement concepts and techniques. This has also led to huge increase in ad spends. The advertising revenues statistics for India, on a calendar year basis, reveal as under:

(INR Billion)

Industry Advertising Revenues	FY 14	FY 15	FY 16	FY 17	FY 18	Growth in FY 2018 Over FY 17
TV	138.4	160.0	183.7	202.6	223.5	10.3%
Print	166.0	179.6	192.3	204.4	210.6	3.1%
Digital advertising	32.5	47.0	64.9	86.2	116.3	35.0%
OOH	19.9	22.3	25.5	28.8	32.0	11.9%
Radio	17.2	19.8	22.7	24.0	25.9	7.9%
Total	374.0	428.7	489.1	545.7	608.3	11.5%

(Source: KPMG in India analysis, 2018)

2. TRADITIONAL ADVERTISING

2.1 Newspaper and Magazines

2.1.1 Advertising one's products via advertisements placed in newspapers or magazines is a typical traditional form of advertising. In addition, the print media also offers opportunities like enclosing promotional brochures and fliers for advertisement purposes. The daily and weekly newspaper ads allow the advertisers to target specific geographic neighborhoods. The ads are often supplemented by incentives, such as coupons printed on the advertisement.

2.1.2 Magazines are durable versions of newspaper advertising. As opposed to newspapers, magazines are usually published on a weekly, fortnightly or monthly basis. Most magazine subscribers retain their copy of the magazines for months and read them more than once. Additionally, magazines are more typically passed on to others and this increases their attractiveness as a media for the advertisers.

2.1.3 The newspapers and magazines sell advertising space and their charges vary according to size of the ad, its position in the publication (front page/ middle page, above/ below the Centrefold), as well on the readership levels of the publication.

2.2 Radio Advertising

Radio advertising is also a familiar form of advertising. The radio signals can reach a large area. Advertisers buy airtime from a radio station to air their ads and their spot ad prices depend upon the duration, time of the day, number of repetitions as well as on the popularity of the programs during which such ads are aired. A major drawback of radio advertisements is the ability for the listener to simply change the station or turn off the radio to avoid hearing the ad.

2.3 Television Advertising

Television advertising reaches the maximum number of target customers and it offers a variety of content which can be effectively used for the ad insertion of ad. It is more expensive advertising, as reflected by the high price for ad spots especially during sporting events.

2.4 Outdoor Advertising

Also known as outofhome (OOH) advertising, this is a broad term that describes any type of advertising that reaches consumers when they are away from home. Instances of OOH can be hoardings, bus shelter boards, kiosks, bus panels, cinema hall advertising and even big digital boards on roads and highways etc.

3. NEW CONCEPTS IN ADVERTISING

3.1 Event Sponsorship

This is known as covert advertising. It can take many forms. The advertised product may simply be orally acknowledged by the organisers of the event/program or the advertisers may get an onsite location to promote their product/service or the company's logo might get displayed on the event site/posters etc. Covert advertising is unique and at times the product or brand is deliberately displayed or shown as part of the background by entertainment and media channels. Though there is no overt commercial advertising but the brand or the product gets subtly showcased and it has a better recall value.

3.2 Surrogate Advertising

Surrogate advertising is usually resorted to in cases where the advertising of the concerned product is banned/ limited by some law or public policy e.g. products like cigarettes or alcohol. To overcome this limitation, the advertisers come up with advertisement of benign products sporting the same brand name as that of the alcohol/tobacco company and the customers get indirectly reminded and influenced.

3.3 Digital Advertising

3.3.1 Online Advertising

Advertisement via the internet can be classified as online advertising. Nearly all websites display ads on their web pages. Another variation of online advertising is called 'Native advertising' which is the use of paid ads that match the look, feel and function of the media format in which they appear. Native advertising is a type

of advertising, mostly online, that matches the form and function of the platform upon which it appears. In many cases, it manifests as either an article or video, produced by an advertiser with the specific intent to promote a product, while matching the form and style which would otherwise be seen in the work of the platform's editorial staff. The word "native" refers to this coherence of the content with the other media that appear on the platform. Native ads are often found in social media feeds, or as a recommended content on a web page. Unlike display ads or banner ads, native ads do not look like ads. They look like a part of the editorial flow of the page. Their readers may not realize they are consuming a paid advertisement. For example, an article about "The Top Five Weekend Destinations in India" may take the reader to the website of a hotel or a tour operator. The Native Ads uses Programmatic Advertising which is defined as the automated buying and selling of online advertising space. The market for digital ad space is run by ad exchanges, who operate computerized auctions that bring together the Advertisers, who want to buy ad space on the internet, and the Publishers i.e. the website owners with digital space to sell. Programmatic advertising uses algorithmic software to handle the sale and placement of ad impressions all in a fraction of a second. It incorporates traffic data and online targeting methods to serve impressions more accurately, efficiently and at scale.

3.3.2 Smartphones

The mobile connectivity offered by smartphones makes it a fertile ground for advertising. Mobile phone apps carry branding and product information for services they offer. Also, the games downloaded onto mobile platforms display ads when connected to the internet. The shift towards increasing smartphone usage has meant that the advertisers and marketers have had to shift their strategies and campaigns in a more mobilecentric direction. For instance, companies without a mobilefriendly website risk losing valuable exposure on Google Inc.'s web search queries because Google recently changed its algorithm so that more mobilefriendly websites have priority placement for search queries made on mobile devices. Another important point for marketers and advertisers is the fact that smartphones are not only receivers but also transmitters of information. Smartphones have become huge repositories of information on individual tastes and preferences. This means advertisers and marketers have the ability to be much more specific in their ad and marketing campaigns, and able to offer more relevant messages to different types of groups or individuals. Ads are becoming more dynamic and personalized.

4. ROLE OF ADVERTISING AGENCIES

4.1 An advertising agency is often an independent organisation of creative people and business people who specialize in developing and preparing market plans, content and other promotional tools for advertisements. The Indian advertising industry has advanced from being smallscale family business to a fullfledged industry. The arrival of multinational companies in India has given this industry an unprecedented boost. The basket of services provided by the advertisement agencies has also undergone a lot of changes. The services provided now range from initial market survey to brand strategy, brand building, media planning, creating advertisement material and its actual release on the various media. Large advertisement agencies have separate departments taking care of different functions, e.g. creative department, client servicing, media planning, media operation, production of films, and accounts etc. There may also be departments looking after direct marketing, public relations, campaigns, exhibitions etc.

4.2 The Advertising agency is a service provider that helps its clients by developing suitable ad campaigns for them. Its role starts with the

identification of its clients' goals and objectives. The creative department performs the function of conceiving the advertisement. The people in this department have sittings with clients to discuss the product and decide the preferred method for promotion. Their aim is to represent its clients' products and services before customers in such a way that a positive image is created in their minds. They conceive and design the advertisement for the clients. The client servicing department performs the function of interacting with the clients on the one hand and with the creative department on the other, so as to get the advertisement ready for release in time. Once the advertisement is ready, the media planning department takes over the strategizing the various media in which the advertisement will be released for optimum impact. This is planned keeping in view the particular focus of the advertisement i.e. whether it is to increase the sales, push new products in the market, restate benefits of the clients' brands, reposition the brand for new customers and retain existing customers etc. They also book the required space on various media at the optimum rates and see to it that advertisements are released in time. The production department's job is to transfer the ideas of the creative department into print, films or other selected medium or software for actual advertising. It gets the necessary material such as bromides, negatives, print blocks etc., ready and hands over the product to the newspaper publishers for the purposes of printing. In the case of advertisement on Television, a short film is shot, processed and transferred to the requisite software which is then given to the media for broadcasting it. The advertising agency's professional teams put in their best efforts to develop attractive slogans and all this is done within the defined parameters of their clients and as per their budgetary allocations.

4.3 The benefits of using an Advertising Agency is that they have the ability to buy media in bulk at rates that a single business cannot economically obtain. They are wellinformed as to the best times and places to run ads in order to reach the target market of the advertisers. They can help advertisers fine tune their target markets so that the message is designed to reach the intended customer.

5. CLASSIFICATION OF ADVERTISING AGENCIES

5.1 Full Service Agencies: A fullservice ad agency is one that provides the whole range of marketing services that are directly related to advertising such as copywriting, artwork, production of ads, media planning etc. It also provides such services in respect of pricing, distribution, packaging, product design etc.

5.2 Modular Agencies: A modular agency is a fullservice agency that sells its services on a piece meal basis. Thus, an advertiser may commission an agency's creative department to develop an ad campaign while obtaining other services from another agency. Or, an advertiser may hire an agencies media department to plan and execute a program for advertising that another agency has developed. Fees are charged for actual work undertaken.

5.3 In House Agencies: Many companies prefer to have closer control over their advertising and they have their own inhouse agency. They perform almost all functions that an outside advertising agency would perform.

5.4 Specialist Advertising Agencies: There are some agencies who undertake advertising work only in certain areas e.g. only in financial services or only in film publicity etc.

5.5 Creative Boutiques: These are shop agencies that only provide creative functions and not the fullservices. The specialized creative functions include copy writing, artwork and production of ads. They charge a fee or percentage of fullservice agencies and over time most of them do convert into a fullservice agency or merge with other agencies to provide a wider range of services.

6. ADVERTISING LAWS IN INDIA

There is no direct legislation on the Advertising Industry as such but there are several legislations which place restrictions on the content and scope of advertisements e.g. Press Council of India Act, 1978; Cable Television Regulation Act, 1955; Cable television Amendment Act, 2006; The Consumer Protection Act, 1986; The Cigarettes and other Tobacco Products (Prohibition of Advertisement and Regulation of Trade and Commerce, Production, Supply, and Distribution) Act, 2003; the Drugs and Magic Remedies (Objectionable Advertisements) Act, 1954; Drugs and Cosmetics Act, 1940; Prenatal Diagnostic Techniques (Regulation and Prevention of Misuse) Act, 1994; the Young Persons (Harmful Publications) Act, 1956 etc. Besides, there are various trade bodies which have set out codes of conduct for the advertisement industry e.g. Advertisement Standard Council of India (ASCI), which was established in 1985 as a nonstatutory tribunal committed to the cause of selfregulation in Advertising, ensures the protection of the interests of consumers. It has come up with a Code of Advertising Practice in order to create a selfregulated mechanism of introducing advertising ethics in India by upon its, also known as the ASCI code. Similarly, the Indian Newspaper Society (INS, Formerly IENS), an autonomous body with members comprising newspaper and magazines, has also developed code of Advertising Ethics, which is followed by its member publications. Another body known as Consumer Education Research Centre (CERC) is also engaged in creating awareness among the consumers against unethical and misleading advertising and fighting the cases against erring advertisers. The Advertising Agencies Association of India (AAAI) is another organisation of advertising agency. The Doordarshan and All India Radio also have an extensive advertising standards code.

7. WORK FLOW IN THE TRADITIONAL FORMS OF ADVERTISING

7.1 The two most critical aspects of advertising through the medium of Print, TV, Radio & Hoardings, where there is possibility of revenue leakages, relate to (i) making of advertisements, and (ii) its publication. The process of making of an advertisement involves various stages:

a. Strategic consultation for communication and advertising of the brand.

b. Conceptualisation of an Advertisement.

c. Film production of an advertisement generally this task is outsourced but it normally is closely supervised by the agency.

d. Adaptation of an earlier advertisement/ advertisement published in other country/ language to the local language.

e. Voiceover services.

f. Designing or advising advertisers on inshop branding, all print collaterals, digital communications like banners, animations etc.,

g. Conducting research for advertisers.

7.2 The agency bills the advertisers for the advertisements either on a costplus margin basis or on man hours spent basis or on a lumpsum basis.

7.3 The work of publication of advertisement involves selection of modes of communication i.e. print, electronic, digital, in consultation with the agency. Due to its experience and expertise and also its bargaining power, the agency assists the advertisers in media buying as under:

a. The agency negotiates with the broadcaster on pricing based on the approved plan from client as regards time slots for publishing and it also monitors the publication.

b. It pays to the broadcaster on behalf of the advertisers and then subsequently recovers the amount from the advertisers.

c. In case of Out of Home (OOH) media it buys the signage on behalf of client. It ensures that the advertisement is actually displayed on the selected sites and monitors the same during the advertisement period.

7.4 The agency charges commission from the advertisers for media buying, selling and related activities. It also recovers the costs incurred by it on behalf of the advertisers and earns commission as well.

8. TAXATION ISSUES IN TRADITIONAL FORMS OF ADVERTISEMENT

8.1 While making the advertisement, a number of expenses are incurred in cash for which proper vouchers are not maintained and at times the cash expenses are also inflated.

8.2 The following heads of expenditure are known for inflation of expenses:

a. Commission, discount & rebate.

b. Employee cost.

c. Payment to artistes, and

d. Business promotion.

It would be worthwhile to examine the books of account and examine the proportion of cash discounts/ rebate/ commission disbursements. Crossverification, wherever possible, will be fruitful. The TDS liability should also be examined in suitable cases.

8.3 Sometimes the artistes/models are paid outside the books of account and expenditures get booked subsequently under other heads, *viz.* conveyance, travelling, sales promotion, staff welfare, etc. By making payments to the artistes/ models in cash, the agencies avoid TDS on such payments also.

8.4 In some cases while the expenditures are claimed in full, the corresponding incomes are not fully disclosed. If there are specific claims of expenses like commission, discount and rebate with regard to a particular activity, particulars of such expenses should be obtained and compared with the corresponding income declared by the agency.

8.5 The advertising agencies maintain a separate account for each advertisement made. It has been observed that after the preparation work of an advertisement is finished, the agencies make provisions for certain ad hoc expenses on the pretext that the client may not approve the entire content. When the said advertisement is finally approved by the client, the provisions are supposed to be reversed. However, the reversal of provisions is often not done.

8.6 Out of home (OOH) players earn revenues from providing hoarding sites to advertisers. One issue in this context is whether such hoardings should be considered as buildings (depreciation rate is 10%) or considered as plant and machinery (depreciation rate is 15%) for purposes of depreciation. It should be noted that usually the hoarding structures which are constructed and erected by the advertising agencies or owners of site are permanent structures embedded in the building and they have a foundation. Where the sites are only rented out to the advertisers, the structures fail the functional test and it cannot be said that these hoarding structures are tools or apparatus with which the owners are carrying on their business. The structures are building simpliciter which are constructed and erected by the owners and which has been given for advertisement to various entities for putting their advertisements on them. They are liable to be treated as a 'Building' which are rented out on commercial terms and conditions for ultimate use as a space by the entities who are desirous of putting their advertisement of products and/ or services on them. Recently one bench of the Income-tax Appellate Tribunal has also held that hoarding structures are permanent structures embedded in the building and it cannot be said that hoarding structures are tools or apparatus with which the taxpayer is carrying on business; rather, these hoarding structures are buildings.

8.7 It should be kept in view that the byelaws about signboards and hoardings etc. are primarily enacted and implemented by the concerned Municipal authorities. Moreover, the rules regarding the same are not likely to be similar in all cities. They also depend on the size of the city e.g. the provisions for Mumbai, Delhi, Hyderabad or Bangalore etc. are likely to be quite different from those in the tierII and tierIII cities. In metro cities, modern types of hoarding like illuminated, neon, electronic and mobile display like auto panel (illuminated) etc. are also provided alongwith the normal types of nonilluminated hoardings and glow sign boards. In general, all such byelaws are likely to have provisions for a certain specified amount of fee/ tax to be paid periodically depending upon types of advertisements/ hoardings, restrictions on size/ height, structural stability, consent of the owner of the property, insurance against third party risk etc. If needed, the assessing officer can contact the local municipal body of his city for obtaining specific details applicable to the city concerned. An advertising agency may try to hide a part of his advertisement activity and thereby the income derived from it. To tackle this, the information available with Local Authorities can be obtained and compared and corelated with the ad agency's admitted income. That the advertiser might have erected unauthorised hoardings behind the back of the local authority is another matter. In such cases a survey or spot verification may help.

8.8 On the question whether a contract for putting up a hoarding would be covered under Section 194C or 194I of the Act, the CBDT in its Circular No. 715, dated 881995 had clarified that the contract for putting up a hoarding is in the nature of advertising contract and provisions of Section 194C would be applicable. It was also clarified that if a person has taken a particular space on rent and thereafter sublets the same fully or in part for putting up a hoarding, he would be liable to TDS under Section 194I and not under Section 194C of the Act.

8.9 In one reported case the advertising agency had been given a license for putting up bus shelters at various places and was also required to beautify the road medians; put up light poles on roads; construct a footbridge and to maintain the same for a specified period. The concerned assessee was permitted to erect advertisement hoardings to recoup the expenditure for the above. No ownership or other right accrued to it apart from the license to earn revenue from the advertisements placed on these structures. The duration of the agreement also indicated that the arrangement was only for a temporary period. In this case, it was held that the income is derived only from the advertisements and it is not income from infrastructure development.

8.10 The advertising agencies are entitled to receive a fixed commission from the media house through which the content is advertised. Moreover, they are also entitled to receive volume incentives which can be in the form of free commercial time or space. The terms and conditions for earning volume incentive are known in advance and this incentive is retained by the ad agency for its own benefit and is not passed onto the client. The incentive could be in the form of free time/space which may be used by the agency to place further ads of its other clients or may even be sold. Such incentives accrue to the agency in the accounting year itself and should be accounted as income of that year itself. However, the agencies account for them in the year only when a formal credit note is issued by the media house. It is also possible that the ad agencies may claim undue deductions from the incentives received by claiming that a part of the same had been passed on to its clients/agents, etc. These need to be checked.

8.11 In the advertising industry there is a possibility of passing off capital outlays as revenue expenditure, be it an advertisement film, a hoarding or any other. The assessing officer should ascertain the complete facts and form his own judgment about the revenue or

capital nature of the outlay. A decision on such claims should be taken after a careful study of all relevant facts and precedents.

8.12 At times certain information leading to detection of undisclosed taxable income can be obtained by the assessing officer himself. In the advertising business, legal disputes between the parties and also between the advertiser and the local authority arise from time to time. The details of these disputes, if gathered, may lead to the detection of certain income and transactions which may not have been declared by the advertising agency.

9. BRIEF BACKGROUND OF DIGITAL FORMS OF ADVERTISEMENT

9.1 The advertisers/ clients in India make use of various digital advertising platforms offered by Google, Facebook, Bing Ads of Microsoft, Amazon, LinkedIn etc. These digital platform companies have setup their advertisement business concerns in lowtax or notax jurisdictions. A few such concerns are Google Ireland Limited, Facebook Ireland Limited etc. These concerns provide digital advertisement services or online advertisement services to clients in India through their associate entities such as Google India Private Limited, Facebook India Private Limited etc., or through any Authorised Resellers/ Distributors. The Indian advertisers run their advertising campaigns on the digital platforms of these concerns by running their ads either manually or by using an automated service or by hiring a digital marketing agency. A digital marketing agency can provide the advertisers with the better analytics and insights regarding the various digital platforms.

9.2 The Google Adwords is the most significant advertising platform in the world today. It offers an opportunity to project one's advertisements directly to the potential customer who use its search engine. Some options available to the advertiser/ client via Google Adwords are:

a. **Search Ads:** These are traditional ads which can be seen when anyone does a Google search. These are usually the top 23 search results above the main organic search result as well as the several ads to the right of the organic search results. Such ads appear on the screen depending upon the specific keywords typed by the users. The advertisers have to compete with others to get top placements and this is usually done through a daily online auction.

b. **Display Network:** The Google Display Network help advertisers to seek out potential customers by reaching out to them when they are browsing their favorite websites, showing a friend a YouTube video, checking their Gmail account, or using mobile devices and apps. This is also called 'ad grouptargeting' to ensure that the ads get seen by specific people or in certain contexts. The advertiser aims to get the ads seen by the specific audiences or demographics. It can also be done by focusing on targeting certain moments. It is usually done by specifying in the computer code the specify keywords or topics which should initiate display of such ads. Google owns various platforms such as Gmail and YouTube where one can place text, image and video ads. Google also partners thirdparty websites. All this gives Google Display Network the biggest reachout of any online advertising platform. While the ordinary Search Network can reach people when they are already searching for specific good or services, the Display Network captures one's attention earlier in the buying cycle. The advertiser can put ads in front of people before they start searching for what is on offer. The display network also reminds people of what they are interested in.

c. **Remarketing:** Remarketing is a feature that lets the advertiser customize its display ads campaign for people who have

previously visited their site. It allows them to tailor the ads (using dynamic remarketing) for these visitors when they browse the web and use apps. This feature is available for both the Search and Display Network campaigns.

9.3 The top 5 social media advertising platforms which are widely used by the Ad Agencies/digital marketing agencies are:

a. **Facebook Ads:** Facebook is the largest social media network in the world, with over 2 billion monthly users. The number of targeting options available on Facebook make it an exceptional ad platform. Facebook lets the advertiser target according to demographic makeups and user interests.

b. **Instagram Advertising:** This channel was acquired by Facebook and is a visual driven platform that consists of videos and images.

c. **Twitter Ads:** Twitter is another popular platform with over 330 million monthly users. This social media platform does very well with e-Commerce sites as it can primarily drive brand awareness and promote products and sale campaigns. Twitter campaigns include promoted accounts, promoted tweets, and promoted trends.

d. **LinkedIn Advertising:** LinkedIn Advertising is used to creating effective B2B marketing campaigns. There are 227 million monthly active users on LinkedIn. This platform will help the client find qualified business leads in particular certain industries.

e. **Pinterest Advertising:** Pinterest is another visual platform similar to Instagram. It is an active platform with 175 million monthly users. Pinterest works well with e-Commerce type sales. Its ads are highly visible to those who are searching or browsing keywords that are associated with the client's product or brand.

10. TAXATION ISSUES IN NON-TRADITIONAL OR DIGITAL FORMS OF ADVERTISEMENT

10.1 The taxability of the incomes of channel/ broadcaster/ server based outside India from advertisement placed by clients in India through local advertising agents is a contentious issue. Many a times the channel/ broadcaster/ server is located outside India and an advertising agent for the Indian territory is appointed in India to book time slots for Indian advertisers. The advertising agent in India receives commission at a fixed percentage of the advertisement revenues which is usually in the range of 10% to 15%. Usually after debiting the various expenses incurred, the advertising agent offers a nominal amount for taxation. However, at times it is observed that these agents have been given the authority to conclude contracts on behalf of the channels/ broadcasters. In such cases where significant economic presence of the foreign entity can be established, it can be held that the channel/ broadcaster/server company is operating in India through the Permanent Establishment of the local advertisement agent and, therefore, the profits attributable to the channels/ broadcasters/ server company from the operations in India is liable to be taxed in India through the advertising agent, being its PE.

10.2 The Advertising, Marketing and Promotional (AMP) expenses form a significant component of expenses incurred by the Indian arm of Multinational Enterprises (MNEs). These expenses are typically incurred to market and build the brand. The Indian entities undertake marketing efforts and activities and incur huge AMP expenses for the development, enhancement, maintenance and exploitation of the brand owned by the overseas Associated Enterprise (AE) and this increases the brand value of the overseas AE. The AMP spend of the Indian entity results in creation and promotion of local marketing intangible which benefits the IP owner i.e. overseas Associated Enterprise of the

MNE. Hence, the entire expenditure or part of the expenditure may not be relevant to the business of the Indian entity and, therefore, such expenses need detailed examination under Section 37 of the Income-tax Act. In order to establish that the expenditure incurred by the Indian entity was not relevant for its business purpose, detailed analysis has to be carried out before disallowing the expenditure/part of the expenditure under Section 37 of the Income-tax Act. This may involve examining the agreement entered into between Indian entity and its overseas AE and actual conduct of the entities (both Indian as well as well overseas) over a period of time, regarding the AMP expenses. The Transfer Pricing division of the Department has also made adjustments on this account in several cases and the issue is before the Supreme Court pending a final decision. In every case of AMP adjustment by TPO, the assessing officer should incorporate a separate paragraph in the assessment order, explaining the facts and particulars of the case and the interplay of Section 37 disallowance and AMP adjustment made by the TPO. However, the assessing officer should not make a double disallowance.

10.3 Though online advertisement is now covered by the provisions of 'equalisation levy' in India, there exist certain types of online advertisements that may be treated as royalty payments. In a ITAT decision in the case of *Google India (P) Ltd vs. JCIT* [2018] 93 Taxmannn.com 183, the payment made by Google India to Google Ireland for buying 'Google AdWord Space' was held to include payment for trademarks, IPRs, brand features, derivative works and other intangibles owned by Google Ireland. Thus, payment for marketing and distribution rights acquired by Google India amounted to royalty according to Section 9(1)(vi) of IT Act and in absence of PE of Google Ireland, it required deduction of TDS under Section 195.

11. INTRODUCTION TO EQUALISATION LEVY

11.1 Companies such as Google, Facebook, Amazon, Alibaba, Yahoo etc. are headquartered abroad and carry on e-Commerce operations across various countries, including India. In India, these companies interact with the sellers and consumers digitally over emails, website and other digital means, without maintaining any physical presence in India. When an Indian entity enters into an agreement with these Companies for advertising its products, it is not easy to tax the advertisement and sales facilitation revenue earned by the non-resident entity since it does not have any physical presence in India. The attempts to bring to tax the payments for such online advertisers by applying the existing provisions of the Indian Income-tax Act and the Double Taxation Avoidance Agreements ("DTAAs") are highly litigated. Further it is also observed that these foreign entities route their transactions through a lowtax jurisdiction, i.e. where the corporate tax rate is low or nil. This leads to nontaxation of income due to base shifting or in simple words profit shifting.

11.2 The BEPS Action Plan 1 of OECD has also identified and analysed various tax models in relation to transactions in the Digital Economy, such as modification of rules relating to 'Permanent Establishment' (PE) to include significant economic presence, withholding tax on digital transactions and also Equalisation levy. Taking a cue from the same, India has introduced an 'Equalisation Levy', which is independent of the domestic income-tax provisions. The Equalisation Levy was introduced through Chapter VIII of the Finance Act, 2016 and has been made applicable w.e.f. 1st June 2016. As per its provisions, Indian resident payers will deduct the amount of Equalisation Levy at source and pay the same to the Government of India. The Equalisation Levy is outside the Incometax Act and therefore, Double Tax Avoidance Agreements are not applicable to it.

11.3 The salient features of the Equalisation Levy as contained in Chapter VII of the Finance Act, 2016 are as under:

a. Clause 163 lays down the extent, date of commencement and provision for application of the Equalisation Levy. It extends to the whole of India except the State of Jammu & Kashmir and it applies to consideration received or receivable for specified services provided on or after the commencement of the Chapter.

b. Clause 164 is the Definitions Clause. As per Clause (i) of Section 164, 'specified service' means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other service as may be notified by the Central Government in this behalf

c. Clause 165 provides for the charge of tax and directs that there shall be charged an equalisation levy at the rate of six per cent of the amount of consideration for any specified service received or receivable by a person, being a non-resident from a person resident in India and carrying on business or profession; or, a non-resident having a permanent establishment in India. The equalisation levy under Sub-section (1) shall not be charged, where:

   (i) the non-resident providing the specified service has a permanent establishment in India and the specified service is effectively connected with such permanent establishment;

   (ii) the aggregate amount of consideration for specified service received or receivable in a previous year by the non-resident from a person resident in India and carrying on business or profession, or from a non-resident having a permanent establishment in India, does not exceed one lakh rupees; or

   (iii) where the payment for the specified service by the person resident in India, or the permanent establishment in India is not for the purposes of carrying out business or profession.

d. Clause 166 provides that every person, being a resident and carrying on business or profession or a non-resident having a permanent establishment in India shall deduct the equalisation levy from the amount paid or payable to a non-resident in respect of the specified service at the rate specified and pay the same to the credit of the Central Government within the time prescribed for the same. The payer shall be held liable even if he does not deduct the equalisation levy.

e. The Equalisation Levy scheme also has provisions for filing of a Statement or the annual return, revision of the Statement, its processing, charging of interest & penalties. It also has provisions for rectification of mistakes. There are provisions for appeals as well as for prosecution.

f. The Equalisation Levy is charged only for services and not on goods and the levy is payable on gross amount. If the Indian Resident does not deduct or pay the Equalisation Levy, the related expenditure is not eligible for deduction as per Section 40(a)(ib) of the Income-tax Act. When an Equalisation Levy is chargeable to a consideration paid for any specified service, any income arising from the specified service is exempt from taxation under Section 10(50) of the Income-tax Act. The assessing officer has to examine whether the services for which the resident assessee is making payment are covered under the definition of "specified services" or not. If it is covered, then the AO will have to apply the provisions of Equalisation Levy and the Income-tax Act will not apply. If the nature of service is not covered as a

specified service, then clearly EL does not apply and provisions of Income-tax Act will be applicable. The Equalisation Levy Rules, 2016 have also been notified on 27th May 2016.

12. POTENTIAL TAXATION ISSUES IN EQUALISATION LEVY

12.1 The definition of "specified service" means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement. However, the terms, 'online advertising', 'provision of digital advertising space' and 'any other facility or service for the purpose of online advertisement' have not been defined in Chapter VIII. As per Clause 161(j) of Chapter VIII, the words and expressions used in Chapter VIII not defined therein and defined in Incometax Act or Rules, shall have the same meaning as assigned in the Act or Rules. However, the aforesaid terms have been defined in the Act or Rules. Therefore, these terms will have to be considered as in their commercial parlance which could be a subject matter of debate.

12.2 The rate of tax under EL is only 6% which is much lower than the normal TDS rates of 10% to 15% for services that are in the nature of Royalty/FTS. This may lead to misdeclaration of specified services to include noneligible services also. The assessing officer should carefully examine the nature of service provided by the non-resident and the manner in which such services have been utilised by the resident taxpayers.

12.3 There can be a case where the resident taxpayer may seek to avoid deduction of equalisation levy by camouflaging it as a payment for purchase of goods or payment for other services that are not covered by Equalisation Levy. The assessing officer should try to obtain details of the relevant transaction between the resident taxpayer and the non-resident company and analyse whether the service provided by the non-resident company falls under the list of specified services or not.

12.4 A question may arise whether the collection agent of non-resident in India is liable for Equalisation Levy. The collection agent in India collects consideration and remits the same to the non-resident which is actually providing the Specified Services. It is possible that the resident taxpayer might claim that the payment is made to an Indian resident (the collection agent) and therefore Equalisation Levy is not required to be deducted at source. However, the moot point is that the collection agent is acting on behalf of the non-resident service provider and is only a passthrough entity and, therefore, equalisation levy has to be deducted by the resident entity on the payments made to the collection agent of a non-resident for the specified services. However, if the Indian collection agent is a PE of the non-resident, in that case the consideration paid to it would be taxable under the Income-tax Act and the same would be liable to TDS under the Income-tax Act only.

12.5 A likely issue could be whether 'Online market places' such as Amazon, Alibaba are providing just a platform to facilitate online trading of goods or whether their services have an element of advertising also. It may also be claimed that the payment to them is not only for online advertising or provision of digital advertising space. However, if hosting the vendors catalogue on the website is an essential part of the services rendered and provides images and other details, it can be partly held as online advertising. The service fee charged by digital market places from various brands may include component for brand promotion of their products on the marketplace and hence the same would be liable to equalization levy.

12.6 The definition of specified services may include the services of hosting paid articles/ reviews/ writeups etc. written with an agenda to promote the brand or products of a resident entity. Such services provided by the non-

resident may amount to booking of digital space by the resident assessee and would consequently attract equalization levy.

12.7 There may be cases where the non-resident might claim that the service rendered is neither covered by Equalisation Levy nor the Income-tax Act. In such cases the AO has to examine the agreement between the non-resident and the resident company, the invoices, bills and other documents to understand the nature of services rendered. After analysing all the information, the assessing officer may take a decision whether the payments made by the resident taxpayer falls under the ambit of specified services covered by Equalisation Levy or not. An alternative approach may also be considered by the assessing officer to verify whether the payments made by the resident assessee can be considered to be in the nature of Royalty/ FTS under the Income Act as well as the DTAA or not.

12.8 Before 1st June 2016, the issue of taxation of Digital advertising or Online advertising has been the subject of consideration in various cases. The assessing officers have explored the taxability angle from the point of view of agency PE; Royalty or FTS. An important decision in favour of Revenue is the case of Google India Private Limited (supra) which was granted the marketing and distribution rights of Ad Words programme to advertisers in India by Google Ireland Limited. The payment made by Google India Private Limited to Google Ireland Limited was held to be in the nature of Royalty. It was observed that the advertisers are paying Google India for being given the right to use the patented technology of AdWords programme and the vast database of customer related information (like telephone numbers, users, behaviors, region, gender, places visited, mobile device used, time spent etc.) and such payments are subject to TDS under Section 194J(c).

12.9 Facebook is the main competitor to Google in digital advertising in India. Like Google, Facebook also earns revenue from advertisements. The technology is similar except for the fact that while the Google Adwords relies on keywords, Facebook relies on user profiles. Facebook has a unique technology which allows the advertiser to directly target the consumer. As per the advertiser's requirement the Facebook Platform runs a continuous advertisement campaign based on the user profiles so that the customers are targeted in an efficient manner. The payments made by Indian Companies to Facebook should also be examined from the angle of being in the nature of Royalty. Similarly, the payments made by resident taxpayers to other such companies should also be examined.

13. CHECKLIST FOR DIGITAL ADVERTISING CASES FOR EQUALISATION LEVY

13.1 The agreement between the resident assessee and the non-resident company should be first examined to verify whether the service is covered under the list of "specified services" of Equalisation Levy. In case of online advertisement payments there are detailed agreements laying down the terms and conditions under which the Indian advertisers can access the Ad Platforms. The agreements contain the definitions of important terms such as:

a. Website
b. Platform;
c. Content
d. Data
e. Use
f. Application
g. Trademark
h. Products,
i. Services,
j. Brand etc.

13.2 These digital advertising agreements contain Clauses that deal with access to:

a. Websites, Advertising platform (APIs and services).

b. Media, brands, trademarks.

c. Information, content and data.

d. Devices, or network.

e. Services.

13.2.1 All the above can be examined for the point of view of Clauses (i), (ii), (iii), (iv), (iva) or (vi) to Explanation 2 to Section 9(1)(vi) also. In addition, the assessing officer may also analyse the Form 15CA/CB data to determine the quantum of payments by the Indian advertisers to non-residents. The email communication between the resident assessee and the non-resident should be sought as this provides a rich source of information regarding the nature of services provided by the non-resident. The employees/persons belonging to the resident taxpayer, who are in charge of the technical aspects of the transaction and the financial aspects of the transaction, may be examined under oath to obtain information.

13.3 The internet can also provide a plethora of information about the online services, the background of the non-resident and the business model used by the non-resident. Several countries have made investigations in the cases of companies like Google, Facebook, Amazon etc. and a substantial information about the investigations is already available in public domain, which can be accessed.

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